TAX SYSTEM REFORM IN RWANDA

Thesis presented in partial fulfilment of the requirements for the degree of Master in Public Administration (MPA) At the University of Stellenbosch

By

Kamasa Rugamba Emmanuel

Study Leader: Prof APJ Burger

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DECLARATION

I, the undersigned, hereby declare that the work contained in this thesis is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

KAMASA RUGAMBA EMMANUEL

Date of submission: ....

ABSTRACT

The implementation of policy reforms in developing countries continues to be negatively influenced by factors such as difficulties with resource mobilization, the dominance of technocratic policy management advocated by donors, and the persistence of state centralism.

Tax system reforms in Rwanda constitute institutional and policy reforms aimed at improving tax compliance and ultimately the contribution of tax revenue to the national GDP. But, because of implementation flaws, including among others the scant flow of technical and financial resources; the dominance of a narrow technocratic approach in implementation; and indeed the failure of the implementers to mobilize political resources and constituent support, the realization of the above objective became a less attainable goal.

This research examines the institutional and policy reforms in the tax system and the dynamics of their implementation, through the manipulation of secondary, numerical and textual information/data on tax system administration in Rwanda. Chapter one of the research deals with the development of the idea to research tax system reform and the formulation of the research problem, hypothesis and methodology. In addition to that, chapter one provides an overview of the tax system reform in Rwanda, a comparative insight into the implementation of reform policies in developing countries, and contemporary experiences in tax system reforms. Chapters two and three, which are formative chapters, focus respectively on the background situations that either influenced or affected tax system reform in Rwanda, and the normative requirements for tax systems.

Chapter four evaluates the implementation of reform and how it concurs with problem situations and normatives. Chapter five is summative in that it provides an interpretation and recommendations, as well as a summary of the research findings.

OPSOMMING

Die implementering van beleidshervorming in ontwikkelende lande word negatief beïnvloed deur faktore soos probleme met die mobilisering van hulpbronne, die oorheersing van die tipe tegnokratiese beleidsbestuur wat deur donateurs voorgestaan word, en 'n voortgesette sentralistiese staatsbestel.

Belastinghervorming in Rwanda omsluit institusionele en beleidshervorming met die oog op verbeterde belastingbetaling, wat tot 'n uiteindelike verbetering in die bydrae van belastinginkomste tot die BNP moet lei. Teenspoed tydens die implementering van die hervormingspoging, onder meer as gevolg van 'n gebrek aan tegniese en finansiële hulpbronne, die bekrompenheid van die tegnokratiese benadering waardeur die implementeringspoging oorheers is, en inderdaad die feit dat die implementeerders nie die nodige politieke middele of die publiek se ondersteuning kon mobiliseer nie, het egter veroorsaak dat hierdie doelwitte moeilik bereikbaar geraak het.

Hierdie navorsing stel ondersoek in na institusionele en beleidshervorming ten opsigte van die belastingstelsel, en kyk ook na die implementeringsdinamiek daarvan. Die ondersoek is gegrond op 'n ontleding van sekondêre numeriese en tekstuele inligting/data oor die administrasie van die belastingstelsel in Rwanda. Hoofstuk een dui aan hoe die gedagte ontstaan het om navorsing oor die hervorming van die belanstingstelsel in Rwanda te doen, en stel die navorsingsprobleem, die -hipotese en -metodologie bekend. Hierbenewens bied hoofstuk een 'n oorsig oor die hervorming van die belastingstelsel in Rwanda, en vergelykende insigte in die implementering van hervormingsbeleid in ontwikkelende lande asook onlangse ervaring wat die hervorming van belastingstelsels betref . Hoofstuk twee en drie is formatief van aard. Hulle fokus onderskeidelik op die agtergrondomstandighede wat 'n invloed op

belastinghervorming in Rwanda gehad het, en op die normatiewe vereistes wat aan belastingsisteme gestel word. Hoofstuk vier evalueer die implementering van hervorming en hoe dit met probleemsituasies en hervormingsnorme verband hou. Hoofstuk vyf is summatief van aard en bevat 'n vertolking en aanbevelings, sowel as 'n samevatting van die navorsingsbevindinge.

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ACRONYMS

ANC	African National Congress
BC	Before Christ
CO	Community Organizations
CSO	Civil Society Organizations
DFID	Department for International Development
ESAF	Economic Structural Adjustment Facility
GDP	Gross Domestic Product
GNP	Gross National Product
HIPC	Highly Indebted Poor Countries
ICHA	Impôrt Chiffre d' Affaire (Turnover tax)
IDASA	Institute for a Democratic Alternative for South Africa
IMF	International Monetary Fund
NGO	Non-Government Organizations
NTA	National Tax Administration
PAYE	Pay As You Earn
PPA	Participatory Poor Assessment
RRA	Rwanda Revenue Authority
RWF	Rwandan Francs
SGS	Soéciété Généralé Inspection
SME	Small and Medium Enterprises
TIN	Tax Identification Number
UK	United Kingdom
VAT	Value-Added Tax

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CHAPTER 1: INTRODUCTION

'The reading of history shows that, the collapse of nations was due often if not always to the mounting ineffectiveness of their tax system" General Douglas MacArthur. [1]

For more than 30 years the tax system in Rwanda, like other systems of the post-independent public sector in that country, has been experiencing continual institutional degeneration, compounded by structural complexities, non-compliance, and subsequently limited returns. This chapter, therefore, provides an introductory overview of tax system reforms in Rwanda, covering the following issues:

- Overview and Policy Shift
- Contemporary experiences
- Problem statement, research questions
- Hypothesis, variables, reform trajectories, and tax reform trajectories
- Theoretical framework which defines tax structure and tax administration as well as other conceptual definitions
- Research methodology, analytical approaches and thesis structure

1.1 OVERVIEW

Compared to other sub-Saharan African countries, the Rwandan tax system has shown the lowest contribution of tax revenue to national GDP (at an average rate of 10%) since 1992. According to the International Monetary Fund (IMF), one of the

[1] General Douglas MacArthur was Supreme Commander of the Allied Forces (SCAP) in occupied Japan after World War II, and is renowned for tax reforms in Japan after 1947 (Shoup, 1989:177).

main multilateral donors to Rwanda (report 4/2000), the poor performance of the tax system in Rwanda is rooted in the low per capita income, the predominance of a subsistence and informal economy, the small size of sectors which are more amenable to taxation such as mining and manufacturing, the wide spread of tax exemptions, poor taxation capacity, and the general lack of compliance with taxation measures.

The significance of this situation is that Rwanda can be technically viewed as a political economy of governance based on fiscal disequilibria and foreign aid dependence. According to the 20-year Development Plan, issued by the government of Rwanda in 2000, for three decades the country had been subjected to revenue challenges such as an unsustainable tax revenue base, lack of indigenous capital accumulation, and dependence on foreign aid.

It is in this context that the Rwandan government from 1995 started implementing a comprehensive set of tax system reform packages, with policy objectives of increasing the quality and quantity of tax revenue contributions to the national economy, by improving tax administration and ensuring compliance (Rwandan Budget Speech 2000). The reform measures were however, formulated and implemented in an unfavourable environment dominated by the impacts of the 1994 genocide and war, which included, the debilitated system of public administration, a shattered economic infrastructure, and pervasive social crises.

Before going as far as to dissect the content of these reforms – which will be done in the next chapters – it can, nevertheless, be argued that, from the perspective of the IMF's diagnosis, the fundamental factor for the poor performance of the Rwandan tax system is based on; poor economic structure, institutional inefficiencies in tax administration and tax structure and culture of non compliance. The reform process was definitely aimed at correcting these historical woes. In the next section we are going to see how the decision of reforming the tax system in Rwanda was taken as part of a broader environment of policy shifting by the new government.

1.2 POLICY SHIFT

Reforms to the tax system in Rwanda did not occur in isolation but were done within the framework of a big policy shift, from the state-controlled economic and administrative systems of the 1970s and 1980s to the neo-liberal policies and approaches adopted by the new government in Rwanda. The two phases of the tax reforms covered in this research were conceived within two macro-economic policy reforms, namely the Economic Recovery Program from 1995 to 1997, and the Enhanced Structural Adjustment Facility (ESAF) from 1997/1999-2000.

According to her first comprehensive policy document, *Towards a New Rwanda (Declaration of the Rwandese Government on the Principles of a Recovery Policy)*, the new government in Rwanda came to power armed with neo-liberal policy instrumental for economic and public administration reforms: greater market liberalization, disengagement of the State from commercial and productive activities, greater regional trade, and reduced public expenditure. The new economic philosophy was shaped by pragmatic analyses of the economic crisis, the views and priorities of donors, and the failure of previous approaches to development, which had been highly interventionist (Humanitarian Assistance Report 1995, unpublished). The performance of these reform policies is not the focus of this research, yet they are providing the context for in evaluating the performance of tax system reforms.

Actually, the fundamental issue here is that the performance of tax system reforms or other macroeconomic policy reforms in Rwanda, cannot be analysed without a reference to the performance of the neo-liberal policy reforms implemented by a number of other African countries between 1980s and 90s. The characteristics of

1980s/90s policy reforms in Africa or in developing countries at large influenced the performance of these policies. Among those characteristics, according to Grindle and Thomas (1991:155) and Schacter (2000:7) include, the deeper involvement of the financial institutions, IMF, World Bank and other Western banking institutions in determining policy priorities for these countries; dominance of technocrats and technical analysis in defining and deciding on courses of action for policy implementation, over multiplication of reform programmes whereby major changes had to be instituted simultaneously; and more importantly, these policies retained the character of being foreign, that is failing to win local ownership. All in all these features had an impact on the success of the policies. Tax reforms were part and parcel of 1980s-90s policy reforms in developing countries, either as part of macro economic reforms or public sector reforms. In the next section, we are going to see some of the contemporary experiences of tax reforms in developing countries.

1.3 CONTEMPORARY EXPERIENCES OF TAX REFORMS

In the 1980s, according to Gillis (1989:8), after the over-pronounced macro-economic crises and crumbling of externally financed public sectors, tax reform became a matter of urgency in countries of Asia, Africa and Latin America. Such reforms were therefore adopted as an immediate policy alternative, in order to rescue shrunken public financing. In the volume of essays on *Tax Reforms in Developing Countries*, Gillis(ed) (1989) noted that the international debt crisis of the 1980s, the decline of commodity prices on the international market, fiscal imbalances and hashed public finances, elicited the wave of tax reforms in developing countries.

The most successful in implementing these reforms were Latin American and Caribbean countries. Included on the list of reforms are the 1981-88 tax reforms in

Indonesia, 1985-90 tax reforms in Bolivia and Uruguay, 1986 and 1988 income tax reforms in Columbia, the 1986 and 1987 tax reform program in Jamaica, and ad hoc tax reforms in Guatemala in 1987. Other reforms are the 1983 tax reforms in Tobago and Trinidad, which were specifically aimed at promoting indirect taxation (Due & Greaney, 1991: 168), and tax reforms in Jamaica in the mid-1980s. When it comes to the causal relationship of failures of economic systems and public sectors management, tax system reform in Rwanda is less different from those above despite of contextual differences.

1.4 PROBLEM STATEMENT

It is identified from the above that the performance of tax system in Rwanda has historically been constrained by the poor economic performance as well as institutional inefficiency associated with poor tax administration. In 1995 the government of Rwanda started implementing a comprehensive tax reform program with objective of increasing the contribution of tax revenue to the national GDP, through improved tax administration and compliance. The reform process was therefore oriented towards administrative reforms and related institutional, behavioral and procedural changes. As it has been mentioned above, despite the historically infallible public sector, the reform process was undertaken in a volatile situation precipitated by the 1994 genocide and war. In any case this situation was compromising the institutional capacity of the government to implement the new policies. It is against this background therefore, that this research is focused on the implementation dynamics of tax system reform in Rwanda.

1.4.1 Research questions

- What is the implementation approach; top-down or bottom-up; exclusive or inclusive?

- What type of new organizational developments and organisational reforms; centralisation or decentralisation?
- Which aspects (contents) of the tax system were reformed; tax structure or administration?
- How did the reforms impact on mobilization of financial, managerial, technical and political resources?

1.5 HYPOTHESIS

The research is aimed at examining how the implementation process conform to trajectories of tax reform, with hypothesis that "*The inappropriate tax system reform trajectories in Rwanda caused unsatisfactory reform outcomes*". This hypothesis can be analysed basing on two variables; *trajectories of tax system reform* as an independent variable and *reform outcomes* as the dependent variable.

1.5.1 Reform trajectories

Trajectories are used to determine the significance and magnitude of reform processes in public sector institutions. Politt and Bauckaert (2000: 68) define trajectories as an intentional, patent-route that someone is taking. It stretches from the starting point to the desired point (Alpha to Omega), spelling out what should be changed and how it should be done and how changes are measured.

1.5.2 Trajectories of tax reform

The implementation of tax reform is guided by the two main components of the tax system, tax administration and tax structure. The composition of these two components makes the trajectories that guide tax system reform. Another important trajectory in tax system reform is how or the process of reform is implemented.

Tax administration includes elements like the simplification of tax procedures, regulations and laws; improving technical capacity for tax administration; tax auditing; efficient enforcement of tax compliance; and information technology.

Tax structure on the other hand, involves the reform of tax bases and rates of taxation.

Tax reform process includes how the stakeholders of tax system-government institutions, citizens and civil organizations were involved, methods of resource mobilisation and management, and political mobilisation. This research on tax system reform in Rwanda is motivated by the patterns and experiences difficulties in the process of implementing reform policies in developing countries.

1.6 MOTIVATION

Our research is deliberately focused on the implementation dynamics of the tax reforms in Rwanda, not necessary to testify the success and failure of tax reform, but also to inform on the importance of understanding that the management of policy implementation is a central factor for policy performance.

The implementation phase of the policy reform process determines the nature and success of the policy reform initiative, yet there is limited attention on the policy implementation stage among policy analysts and policy makers. It is a crucial and important stage in policy making which appreciates political, managerial, technical and economic capacity of the policy, these variables need a continuous and in depth study in order to realise the policy performance. Actually, the attaining of the above variables is an outstanding measurement of the policy success.

It is not uncommon, however to find that the process of policy implementation leads to outcomes quite different from those intended or anticipated by the policy makers. This is the result of a gap between policy design and policy implementation, entailing that the entire policy content and policy results rely on policy implementation.

There has been a tendency among the policy analysts and policy makers, especially in developing countries, where policy formulation has been widely dominated by foreign technocracy to evaluate policy performance depending only on policy results while neglecting the dynamics of implementation. Such evaluations have been giving incomplete information on either success of failure of the policy. To day policy analysts in developing countries are challenged to shift the focus of their analysis from the policy contents to the implementation dynamics of policies in order to draw the true colour of policy management in developing countries. The implementation of tax system reform is generally a practical exercise in public administration, but also needs theoretical foundations.

1.7 THEORETICAL FRAMEWORK

Literally, tax reform is a change in the tax system. Ahmad and Stern (1991:2) conceive tax reform as a remedial measure. Tax reform, as opposed to tax design, is concerned with the search for and analysis of tax systems that would be an improvement on the existing state of affairs. Tax reform is therefore nothing other than an attempt to improve the tax system for better delivery. Tanzi (1991: 171-172) makes a similar observation that tax reform is principally aimed at creating fiscal equilibrium by means of an efficient tax system. The idea is to minimize current expenditure, while upholding capital accumulation.

Essentially, the implied and applied versions of tax system reform by Ahmad and Stern and Tanzi above , provide the bottom line for tax system reform. First and foremost, tax system reform is a remedial measure applied to crises in public finance, referred to as fiscal disequilibria by public economists. In normal circumstances government revenue, or tax revenue for that matter, must cover the cost of public sector expenditure on health services, education, security, public infrastructure and administration. When the government's revenue is surpassed by its expenditure, public finance becomes characterized by fiscal imbalances.

Blumenthal (2000: 351), explicating on the objectives of tax reform, notes that a good tax system is one which achieves three main objectives: efficiency, simplicity and equity. In other words the ideal tax system does not distort economic behavior (efficiency), is borne in a fair manner by differently situated taxpayers (equity), and is easy to understand and to comply with (simplicity).

Implicitly, therefore, tax system reform is aimed at creating an ideal administrative and technical atmosphere for generating more tax revenue in the public sector, while exerting the same measures in controlling the expenditure.

1.7.1 Research area

As can be seen from the above, tax system reform involves reforming both revenue institutions and institutions for expenditure control and management. This research, however, is focused on the first part, that is, changing revenue administration, including reforms in procedures, regulations, structures and compliance, in accordance with two guiding trajectories: tax structure, and tax administration.

1.7.1.1 Tax structure

The tax structure is composed of the tax base and tax rates. The tax base includes a valuated tax object for taxation. If for example income is an object of taxation, the tax base therefore will include personal income tax, corporate tax and profit tax. Tax administration is a mosaic of mechanisms and institutions of the tax system; through which tax bases and tax liabilities are determined (Gillis, 1989: 10).

1.7.1.2 Tax administration

Tax administration is the "real policy of taxation". It deals with the legal and procedural framework of the tax system - tax assessment, collection, auditing, sanctions, appeals and record keeping as well as tax information management. Tax administration is the qualitative aspect of a tax system, which must be properly organized, well equipped especially with regard to information technology, and staffed with well-trained, motivated and innovative staff.

However, the apparent tendency has been not to wed the two components properly in designing tax reforms. Experience shows that in some reforms more emphasis was placed on reforming tax structures while neglecting the effect of tax administration in the process. Subsequently some of the tax reforms would end up being unsuccessful or only partially performed. Intrinsically, long-standing flaws in the tax structure are mostly aggravated by the underlying weaknesses in tax administration (Gillis 1989: 504-5).

Bird and De Juntscher (1992: 1) note that the best tax administration is not simply one that collects most revenue. More important is how that revenue is raised, that is, the effect of the revenue generation effort on equity, on the political fortunes of the government, and on the level of economic welfare.

A poor quality tax administration may collect large amounts from easy-to-tax sectors, such as wage earners, while it is unable to enforce taxes on business enterprises and professionals. The level of collection is therefore a somewhat unsophisticated measure of the effectiveness of tax administration. The more accurate measure in tax administration is the size of the 'compliance gap', that is the gap between actual and potential tax revenue, and how that gap varies among the different sectors of the tax-paying population.

The two tax analysts, Bird and De Juntscher (1992: 3) provide three preconditions for the reform of tax administration:

- Simplification of the tax system, to ensure that it can be applied effectively
- Strategy and a comprehensive plan that assigns clear priorities to the task that must be performed, tailored to the available resources
- Commitment – from policy makers as well as from managerial and technical levels.

1.7.2 Conceptual definitions

Tax system

The tax system of a country consists of two interdependent principal elements, tax structure and a mosaic of mechanisms and institutions for tax administration and tax compliance as referred to above.

Tax structure

It is a configuration of the tax bases and tax rates provided for in legislation. Tax structure is the most visible component of the tax system (Gillis, 1989: 12).

Tax base

It is an objective basis for the levying of tax, depending on valuation. There are a number of possible tax bases, and these may differ from one country to another. Among the possibilities are income tax, which is levied upon the individual or company's income; sales tax levied on goods and services supplied in the market; property or wealth taxes levied on individually owned properties; and taxes from sales of goods and services in the international market. Tax bases differ according to political and economic circumstances.

Broadening of tax base

It is an approach of governments to enlarge the size of the tax net by enlarging the tax base, in order to accommodate more incomes, goods and service to be taxed. There are two ways of broadening the tax base. One is to identify something new to be taxed, for example adding non-profit making organizations onto the schedule of company taxes, and another is to expand the existing tax instrument.

Compliance

There are various definitions of the term, but compliance is usually defined in terms of the degree to which a taxpayer complies with a tax law (Nobes & James 1997/98:137). No tax system can function effectively without the cooperation of taxpayers; compliance therefore means the cooperation of a taxpayer in the taxation process. The broader definition of tax compliance would be the degree to which taxpayers comply with tax law and tax administration without the need for enforcement activities (Nobes & James 1997/98:138).

Compliance without enforcement measures reflects the efficiency of tax administration achieved through civic education measures and the building of trust between taxpayers and tax authority. Radian and Sharkansy (1990:106) regard voluntary compliance as central to tax policy, as an instrument that can enable tax administration to collect taxes from large masses of taxpayers. These two tax analysts confess that without voluntary compliance the process of eliciting taxes from large masses would overwhelm agencies. Currently there are two approaches to ensure compliance. One is the **carrot and stick approach,** which means the use of punitive measures to compel people to comply with tax laws. The second approach is referred to as the **responsible citizen approach**, or voluntary compliance, which is supposed to be attained through sociological and psychological means, by mobilizing and providing civic education to citizens (taxpayers). Modern tax reformists advocate this approach as a method of reducing the cost of tax administration.

1.8 PURPOSE

This research is based on an unfolding of relevant information on the transformation of the tax system in Rwanda, and its future significance in the management of the tax system in Rwanda. The objectives of this paper therefore are to:

- Evaluate the current process of reforming the tax system in the country
- Identify possible shortcomings and make possible recommendations for improvement
- Stimulate intellectual, professional and academic debate and research on a productive and sustainable tax system in Rwanda.

1.9 METHODOLOGY

This research is applied research aimed at collecting and analyzing existing data/information on the tax system reform in Rwanda, so as to generate relevant information and knowledge on the policy of reforming the tax system in Rwanda. In other words, the research is based on secondary data/ information for analysis, and the sources of information were library collections, books and journals as well as on-line information. The main source, however, has been public documents issued by the government of Rwanda, including the annual reports of the Rwanda Revenue Authority, the Rwanda Development Indicators for 1999 and 2000, policy documents including a number on tax legislation passed in relation to tax system reform, national budget speeches and other government policy papers including the 20-year Development Plan (2000). Information was also collected from reports and documents on Rwanda issued by the IMF and World Bank.

Research on tax reform is policy analysis research. According to Manheim and Rich referred to by Fox, Schwella & Wissink (1991: 306) policy analysis can take six approaches: correlative analysis, behavioral analysis, institutional analysis, process analysis, decision analysis and impact analysis. The analytical approach used in this research includes mainly the following:

Institutional analysis, in this case tax system reform in Rwanda has been analyzed according to the laws and procedures involved in the process and institutional arrangements for decision-making.

A *behavioral approach* was applied to examine how the reform focused on changing individual behavior, motivation, social relations and groups involved in tax reform. This also involved altering values and ways of thinking within government institutions.

A *process approach* was used in answering questions of who, what, where, when and how, both at the level of policy planning and of policy implementation with regard to the tax system reform.

1.10 BREAKDOWN OF CHAPTERS

This thesis is composed of five chapters (see figure 1)

Chapter One: This is the introductory chapter and deals with the conceptualization of the research problem, hypothesis and methodology.

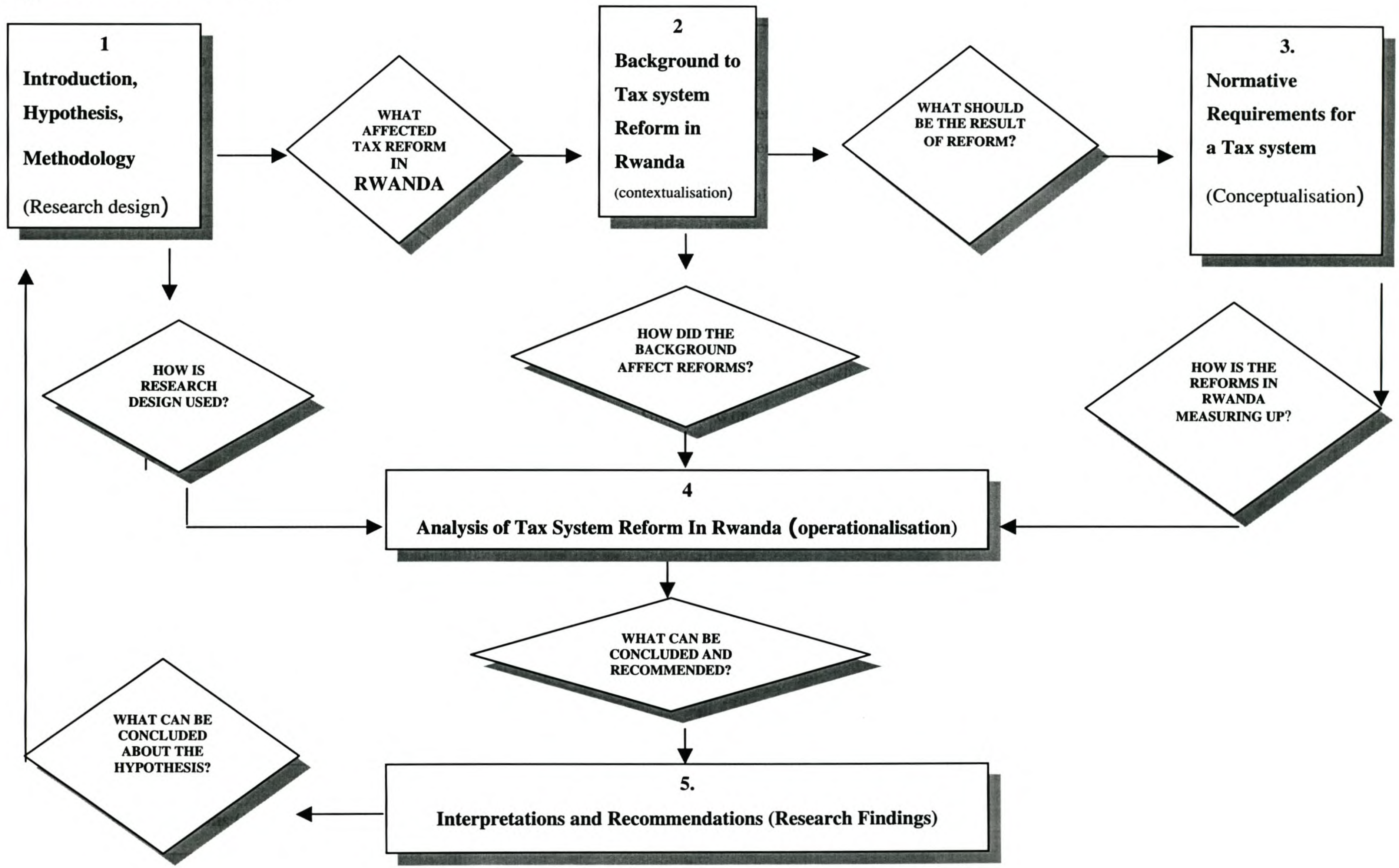
Chapter Two: As background to tax system reform in Rwanda, this chapter covers mainly those preceding situations that might have affected or influenced tax system reform in Rwanda.

Chapter Three: This chapter deals with the normative requirements for a tax system – the chapter generates theoretical and conceptual information on tax system reform and on the principle of taxation in general.

Chapter Four: This chapter provides the analysis of the implementation of the tax system reform in Rwanda from 1995 to 1999.

Chapter Five: Salient features and research findings are analyzed and synthesized in this chapter, and finally a summary and recommendations are provided.

Figure 1: Thesis structure



1.11 LIMITATIONS.

The availability of information has been the main issue of concern. The shortfall of information on Rwandan public sector is deep rooted in the absence of information systems in the public sector and as lack of information management skills and policy. Apart from the fact that there is a general shortage of information, even that which is available is not easily accessible to the public because of highly bureaucratized information management. According to IMF report 4/2000 accesses to official information in of Rwanda has been an issue even during and after the 1994 genocide.

1.12 CONCLUSION

By and large this chapter has portrayed the scenarios which led to the development of the research idea. All in all, tax system reform in Rwanda was inevitable as even other areas of public sector had to undergo reforms for reinstitutionalisation of the state in that country after a history of institutional decadence and for strengthening the indigenous source of revenues. The chapter provided the basic elements which had to guide the research, including; the rationale of doing this research, a brief theoretical framework, a statement of the research problem, the hypothesis and the research design methodology. In the next chapter we are going to look at the background to tax system reform in Rwanda.

CHAPTER 2: BACKGROUND TO THE TAX SYSTEM REFORMS IN RWANDA

2.1 INTRODUCTION

"*.... Specific reform initiatives don't emerge in a void, nor are they decided upon in isolation of preexisting perceptions, experiences, and values of policy elites, or conditions of the political economy" (Grindle & Thomas 1991:43).*

Chapter 1 introduced the conceptual foundations of the research problem, and put forward the hypothesis and research methodology. The chapter also presented experiences of tax reforms in other countries, a brief review on the nature and characteristics of policy reform in developing countries, and finally the theoretical framework of the research. Chapter 2 will explore the economic, political and social background that necessitated and obviously affected decisions about and the process of implementing tax system reform in Rwanda. The following issues will be addressed:

- Historical context of the tax system in Rwanda
- History of budget deficits
- The genocide and its related fiscal, economic, administrative and social effects
- Structural issues, including poverty, debt, primary sector of production and the composition of the tax system in Rwanda

2.2 HISTORICAL CONTEXT

A country's tax system usually develops hand in hand with its economic, administrative and political systems. This is not really the case in Rwanda's situation, however. Rwanda is a rural country, where about 90% of the population is engaged in subsistence agriculture. It is the most densely populated country in Africa, it is landlocked, has few natural resources and a limited industry. Primary exports are coffee and tea. The 1994 genocide decimated Rwanda's fragile economic base, severely impoverished the population, particularly women, and eroded the country's ability to attract private and external investment.

Rwanda is among the poorest countries in the world. Its political history of civil wars, *coup d'états* and recently, the 1994 genocide, has been documented widely and abundantly across the globe. The country has been under foreign domination for most of its modern history; from 1889 to 1945 it was ruled by Germany, and from 1945 to 1962 it was under Belgian domination. Like many other former colonies in Africa, the post-independent Rwandan government continued to run the country in a neo-colonial fashion. Its political and economic structures encouraged foreign dependence and state control.

Taxes were the result of an historical and economic malady. Taxation in Rwanda is not an indigenous institution. It came with the introduction of a cash economy during colonial times at the end of the nineteenth century. Germany in 1889 introduced cash crop production, mainly of coffee and tobacco, to the indigenous rural agriculture. The idea was to connect the Rwandan primitive farmers to global commerce, so that they could raise their own revenue and support the colonially introduced modern public administration (Dorsey 1994:10).

After the World War II, the Belgians stepped in with a slightly more streamlined and dual system of taxation. In this new system taxes were collected from European, commercial and administrative areas in one part of the system, and from the indigenous rural population in the other. Unlike the Germans, the Belgians developed a rudimentary and consolidated system of tax administration, where – although it involved monarchical authorities and notables – the harsh control of the process was maintained in the hands of the Belgian administrative apparatus. The substantial element of the Belgian tax administration, however, was the allocation of 10% of the collected tax to the traditional leaders. The king took 5% and the rest went to the local chiefs. Belgian colonial government adopted this system as a measure to control corruption among chiefs (Dorsey 1994:10-11).

Because of insufficient administrative staff, the Germans depended on local chiefs for the collection of taxes. It is important to note, however, that pre-colonial Rwanda was among only few African communities, which had developed a centralised political system under the monarchy. The king was the head of public affairs, assisted by notables. Apart from the military and traditional judicial institutions, there were no other public institutions. Basically there was no cash-based tax system, although citizens were expected to pay tribute to the king in the form of cattle and labour.

The post-independent government did not do much to improve the tax administration or the economic situation. As was revealed in chapter one, according to the International Monetary Fund (IMF), the continued poor performance of the tax system in Rwanda was rooted in the low per capita income, the predominance of the subsistence and informal economy, the small size of sectors that are more amenable to taxation such as mining and manufacturing, the wide spread of tax exemptions, a weak taxation capacity, and the general lack of compliance with tax regulations.

The contribution of tax revenue to the total national revenue in Rwanda has been significantly poor, compared to other African countries south of the Sahara. The statistics provided by the government of Rwanda in 1999, shows that tax revenue as a percentage of the GDP in Rwanda between 1990-91 was 10.2%, while in other sub- Saharan African countries it was 12%. The same applies for 1996; in Rwanda tax revenue figures per GDP was 9.1%, while in Zambia it was 18.7%, in Kenya 27.1%, and in Botswana 49.6% (Rwanda Development Indicators 1999). In 1992-93 the ratio of tax revenue in Rwanda dropped from 10.2% of GDP in 1990-91 to 9.1%, while in 1994 during the war and genocide the tax ratio dropped tremendously to only 3.6%. The tax system in Rwanda has historically been struggling in a fiscal and structural disequilibrium and lack of institutional capacity; the next section analyzes these issues in detail.

2.3 FISCAL DISEQUILIBRIUM

Public finance in Rwanda has been characterized by crises with regard to balance of payments and budget deficit. In 1979 the resource balance, was –86 million US $, while in 1989 has increased to -250 million in 1998, and -304 in 1999 (World Bank 2000). The current account in GDP percentage in 1995 was –19.0%, while in 1996 the current account balance was also –19.0%. It went down further in the succeeding years of 1997 –17%, 1998 –16.9%, 1999 –15.3%, 2000 –16.8% (IMF notice no. 01/31).

Budget deficits have been a predominant issue in the Rwandan economic structure. In 1982-86 government development plans had a budget of US $ 143 million, but 62% of it was funded by external aid. Likewise in 1987 ordinary government expenditure amounted to US $ 297 million; US $ 209 million of this was funded by external capital (Africa Today, 1991: 1537).

Essentially the incompatibility between expenditure and revenue generation has been a constant problem. In 1993 revenue collection declined at an estimated rate of 6%, but expenditure increased at an estimated rate of 5%. The following year, in 1994, the budget deficit amounted to 16% of GDP (Misser 1995: 207). In 1995 government expenditure was 62 million Rwandan Francs (RWF); the collected revenues were 23 million RWF (Egboo 1997: 172). From 1994 to 1998 the new government experienced a constant budget deficit. Table 1 shows the deficit trend from 1994, when the budget deficit amounted to –19 million Rwandan Francs (RWF). It dropped to -8.0 million Rwandan Francs (RWF) in 1995, while in 1996 it shot up to -24 million RWF; it was -3.8 million in 1997 and is estimated to be –18.4 million by 1998.

The wage bill has been a core factor in the budget deficit. In 1992 the wage bill in the government sector was 5.4% of GDP, and in 1993 the wage bill was standing at a rate of 15.7% of the national GDP. The ratio dropped during the war in 1994 to 4.0% of GDP. In 1995, the rate went up again to 4.4% of GDP; in 1996 the rate was also 4.4%. But it slowly picked up; in 1997 the wage bill stood at a rate of 5.5% of GDP. However, in 1998 the wage bill declined to 4.6% of GDP after massive downsizing of the public service (IMF no 98/2001).

The wage bill in Rwanda has been taking up almost half of the national tax revenues. This trend is shown in Table 3, which indicates that in 1992 the wage bill was 53% of total revenue. In 1993 annual increases in the public sector pushed the wage bill to 67% of total revenue; it then shot up in 1994 to 110% of total revenue. In the succeeding years of 1995 and 1996 it dropped slightly to 62.7% and 53.8% respectively. Compared to other sub-Saharan African countries, the Rwandan wage bill has been high. In 1992, the average wage bill in these countries was 44.3% of total revenue, while in 1994 it was 48.1%. The civil service in Rwanda employs less than 7% of the labor force.

2.4 THE 1994 GENOCIDE AND ITS EFFECTS

Rwanda a hitherto largely unknown and obscure country, thrust itself onto the centre of world attention through the perpetration of the worst acts of genocide in latter half of 20th century, where about between 500,000 to 800,000 (other statistics make it 1 million) people *were killed. The impact on the economy, and psychosocial well being of the populace was incalculable. Infrastructure, including hospitals and clinics and others were either destroyed or damaged beyond repair. Also as the consequence of the killings, Rwanda's human capital was devastated leaving both private and public institutions in disarray* (Duly 2000:1).

The tax reform program in Rwanda was launched in 1995, in the wake of the 1994 genocide fiasco. It was a difficult period for the formulation and implementation of reforms. First there was the problem of institutional and policy capacity. The new government had been in power for less than a year. The institutional problem did not just involve the question of inexperienced personnel; rather more serious was the issue of an institutional vacuum. During the time of execution of, and resistance against the genocide, the government in power fled the country with almost all senior officials in public institutions and public documents.

Administrative institutions like the civil service, government ministries and courts stopped functioning. The reforms were therefore instituted amidst the social, political, and economic disarray of the genocide. The next paragraphs contain an attempt to show the fiscal and economic effects, and institutional and social factors and their effects on the tax system.

2.4.1 Fiscal and economic effects

According to Misser (2000), during and after the genocide the government's total tax revenue, as indicated in Table 2 dropped drastically from 9.6% of GDP in 1993 to 3.6% of GDP in 1994, and 6.9% in 1995 (while non-tax revenue were at zero rates, meaning that the government revenue was depending on tax revenues). The demand schedule was aggressively rising in the adverse economic and social situation resulting from the genocide and political upheavals; about 3.5 million people were considered internally displaced, while about 2.5 million had fled the country.

Table 1 Government finance 1994-98 (in billions Rwf)

Government finance	1994	1995	1996	1997	1998est
Total revenue	7.5	61.5	70.8	95.9	99.0
revenue	6.0	23.1	39.4	58.1	66.0
grants	1.5	38.4	31.4	37.8	33.0
Total expenditure and net lending	26.6	69.5	95.3	109.6	117.4
Current	22.2	42.1	55.9	64.0	75.3
Capital	4.4	27.4	39.4	46.1	42.3
Domestically financed	0.3	0.0	0.0	0.1	2.5
Externally financed	4.1	27.4	39.4	46.0	39.8
Net lending	0.0	0.0	0.0	-0.5	-0.2
Overall deficit including finance	-19.1	-8.0	-24.5	-13.8	-18.4

Source: Rwanda's authority and IMF (IMF 98/200)

The genocide calamity affected the tax system in the country intensively. Most economic and social activities were coming to a halt, most sources of tax were ravaged, while government expenditure was increasing in order to support genocide victims and finance the new administration (Ocheing, 2000: 203). The scale effects on national expenditure were aggravating. It was estimated that during the genocide about 1 million people were killed, while another 3.2 million were internally displaced and 2 million people were estimated to have fled the country to the neighbouring countries. About 47% of the families in the country were estimated to have either females or minors as head of the family, these including the high population of widows and orphans. All this was putting a strain on the government budget (Oxfam 1999, Rake, 1995-96 & Ocheing 2000).

By the end of 1995 it was estimated that the government expenditure would be 62 billion RWF, while the collected revenue stood at only 23 billion RWF, which was just 7% of GDP. The biggest share of the expenditure was being channelled towards reviving the administrative system of the central government (Egboo, 1997:172). In addition to that, the state of government's revenue sources was also depressing, with a slim contribution of non-tax revenue to the total revenue. As indicated in Table 2, in 1994 non-tax revenue was contributing 0% to total national revenue, in 1995 slight progress was recorded at 0.4%. Tax revenue in 1994 was contributing 100% of total national revenue, while in 1995-tax revenue was contributing 93.5% to the total national revenue (IMF no 98/0115).

In 1995, government had estimated that about US $ 800 million would be needed to get the economic and social situation in the country on track. The government therefore opted to approach donors. At the first donor conference in Geneva in 1995, the government of Rwanda tabled a budget of about US $ 617 million that was expected to support a reconstruction and rehabilitation program, but received a mild response. By the end of 1996 according to Egboo (1997) out of US $ 517 million pledged by donors only US $ 69 million had been disbursed The fiscal impacts of genocide were also accompanied by social and economical, developmental woes including, fall of food production; shortage of human resources, fall of exports, import increases and excessive tax evasion.

Table 2 Budgetary receipts between 1991-1998 (%age)

	1991	1992	1993	1994	1995
Total revenue	10.04	10.1	9.1	3.6	6.9
Tax revenue	9.1	8.9	8.4	3.6	6.9
Tax on income and profit	2.2	2.2	2.1	0.9	0.8
Companies	0.6	0.9	0.9	0.4	0.3
Individuals	0.9	0.7	0.7	0.2	0.5
Others	0.5	0.5	0.5	0.2	0.1
Property tax	0.2	0.2	0.2	0.1	0.2
Taxes on goods and services	3.7	3.4	3.6	1.4	2.9
Excise taxes	2.2	1.9	2.1	0.7	1.7
Turnover taxes	1.2	1.0	1.0	0.6	0.9
Road fund	0.3	0.5	0.6	0.1	0.4
Taxes on international trade	3.2	3.1	2.5	1.3	2.6
Import taxes	2.6	2.6	2.5	1.1	2.0
Export taxes	0.5	0.5	....	0.1	0.5
Other taxes	0.1	0.1	0.1	0.1	0.1
Non-tax revenue	1.3	1.3	0.7	.	0.4

Source: IMF

2.4.1.1 Food production

The output with regard to food production during and after the genocide was estimated to have declined by one third, while the output in the transport and communication sector was estimated also to have declined by seventy five percent. The livestock herds that used to contribute about 5% of the national GDP were completely wiped out. Public assets, including buildings and other infrastructure were damaged and looted. The administrative institutions including banks, courts and policy units had either been shut down, or were rendering a diminished service.

2.4.1.2 Civil service

By the end of the war and genocide the new government was facing the virtual collapse of its administrative capacity, both at the central and local levels. The delivery of social and financial services was being paralyzed owing to the shortage of skilled personnel. During 1991-93, the number of civil servants was estimated to be at 41,000, but shortly after the genocide the number fell by about 40% to reach an estimated 25,000 as many officials were either killed or have fled the country (see Table 4).

2.4.1.3 Export

The export sector was disproportionately affected by the genocide. By the end of 1994 the export volume had declined at a rate of 60%. Coffee, which is the main export commodity of the Rwandan economy, was adversely affected. The number of coffee growers in rural households declined to 38% compared to 54% before the war (IMF no. 98/115). The production of green coffee dropped from 27.0 in thousands of tons in 1993 to 21.0 thousands tons in 1995 and to 15.0 tons and 14.8 tons in 1996 and 1997 respectively. The production of tea, which is the second most important export product, had also sharply declined. The production of green tea leaves dropped to 18,567 kilograms in 1994 from 46,945 kilograms in 1993, while dried leaves production went down from 11,181 kilograms in 1993 to 4,136 kilograms in 1994. Between 1994 and 1995 coffee exports were placed below 40% and the export of tea below 30% (IMF no. 98/115).

Table 3 Government sector wage bills, 1992-98) (Source: IMF 2000)

	1992	1993	1994	1995	1996	1997
Wage bill in percent of GDP	5.4	5.7	4.0.	4.0	4.4	5.1
Wage bill in percent of revenue	53.3	67.8	110	62.7	52.8	52.3
Average wage per civil servant per month	22,622	23,119	13,457	15,988	24,368	27,889
Average wage per Civil servant in percent of Per capita GDP	9.3	9.6	...	3.3	4.1	4.6
Average for Sub Sahara Africa wage bill in percent of GDP	8.2	8.0	7.1	7.1	7.0	7.0
Average for sub-Saharan Africa; wage bill in percent of total revenue	43.3	45.3	41.8	37.1	36.4	35.6

2.4.1.4 Imports

Economic statistics after the genocide indicate that the import sector happened to perform better than other sectors. In 1994 import volumes stood at about 30%. This was the result mainly of the bourgeoning of humanitarian assistance to alleviate suffering after the conflict, estimated to be 350 billion RWF. These amounts had no direct impact on the revenue status of the country as most of them were in the form of non-budgetary humanitarian grants. Nonetheless the shortage of outputs (supply of goods) and the inflow of humanitarian aid capital created a buoyant demand, which led to a surge in consumer price inflation of 64% in that year despite a contraction of money.

2.4.1.5 Tax failure 1995-1996

Two years after the 1994 genocide, mainly foreign non-governmental organizations (NGOs) took the lead in importing and supplying consumer and capital goods owing to the absence of government and other economic operators. By 1995 there were about 140 foreign NGOs in the country, including UN agencies, churches and various other types of non-governmental organizations (Humanitarian Assistance Report 1997). These organizations were conducting different socio-economic transactions in the guise of relief services that were automatically tax-free.

NGOs became the main employer in the country and paid high salaries. Apart from the fact that their activities were not taxed, their well-paid employees were not taxed either since no taxes were deducted from their wages. This means that for two years after the war, between 1994-95, both individual and corporate incomes fell outside the tax net. Some workers in the public sector were in double employment. An employee would be receiving his or her basic salary from the government, while at the same time being paid a premium by an NGO. Sometimes this was more than the government paid. This was common practice in public projects run jointly by the government and an NGO.

In actual fact, taxable personal and company incomes were hard to detect. Tender services to the government were supplied through NGOs under the banner of assisting government administration, thus causing the mushrooming of unregistered supplying and construction companies.

The new government elites, including senior military officers, became the main beneficiaries of the situation. Government officials, a small number of elites employed by NGOs, and the newly emerged small group of 'speculative businessmen' formed a cluster of speculative local investors, who transferred NGO capital to small restaurants, unprofessional shops, and non-registered construction companies, in all types of unprofessional cash transactions. The three groups formed an economic class that thrived on tax evasion facilitated by the government officials and to some extent senior military officers. Nevertheless the 1994 genocide did not only cause the above social and economic malady, but also worsened structural and institutional problems, including tax system faced by the Rwandan economy, since independence.

2.5 STRUCTURAL AND INSTITUTIONAL ISSUES

In the above sections we saw that a trend of adversarial economic and fiscal circumstances dominated Rwanda's economic history, and that the effects of the 1994 genocide worsened the situation. Rwanda also had structural problems as was mentioned in the introduction to this chapter, the 1994 genocide just intensified the situation. The structural crisis in the Rwandan economy relates among other things to poverty, indebtedness, and the dominance of the primary sector of production.

Table 4 Size of civil service, 1991 – 98 (in number of persons)

	1991	1992	1993	1994	1995	1996	1997	1998
Employment	41,529	40,153	42,027	25,389	31,794	34,882	40,622	40,204
Teachers	22,473	23,235	27,046	18,440	19,778	22,865	26,740	28,8363
Non teachers	19,056	16,918	14,981	6,949	12,016	12,017	13,882	11,341
Health	5,202	5,202	4,452	2,280	5,064	4,357	4,759	2,706
Others	13,854	11,716	10,529	4,669	4,652	7,660	9,123	7,635
In percent of population	0.6	0.5	0.6	0.3	0.4	0.4	...	...
Sub-Sahara average per population	1.3	1.2	1.2	1.1	1.0	1.0	...	...

Source: IMF/ 2000

The 20-year National Development Plan, a policy paper issued by the government of Rwanda in 2000, outlined the following structural problems in Rwanda;

- The country has a largely subsistence economy which has changed little since independence
- The agricultural sector is characterized by low productivity, low value, and low skills, which has worsened over time especially since the early 1980s, when the agricultural sector reached the frontier of extensive

agriculture but failed to make the transition to intensified and high-value production

- Over half of the population of Rwanda lives below absolute poverty levels; the number has increased since the genocide in 1994
- Human resources are underdeveloped, even by sub-Saharan African standards, especially in the field of science and technology
- The country is land-locked, with a high cost of access to the ports and 72% of traffic being routed by the Northern Corridor road system
- Public and private sector capability is underdeveloped
- The country has an undeveloped middle class and low levels of entrepreneurship. Industries enjoy high tariff protection, are dependent on imports for raw material (over 80%) and are mainly import substituting. Industry provides employment to less than 2% of the population and it provides less than 20% of GDP
- There is a low level of savings and investments. Overall savings are –7% of GDP. The level of investment is 10% of GDP while the average savings rate in sub-Saharan Africa is 8% and that of investment 21%
- The market size is small, with overall domestic demand of about 1.8 billion dollars
- The country lacks viable natural resources capable of kick-starting the economy and needs development in exploiting those that are known and
- identified, especially natural gases and minerals. The implication of these structural deficiencies is the permanent history of poverty in Rwanda.

2.5.1 Poverty

In 1996 the World Bank classified Rwanda as one of the poorest countries in the world, with its per capita income of US $80, and about 70% of the population living in absolute poverty (Oxfam, 1999; Misser 1997: 923). Rwanda is a tiny country in central Africa, with a population of 8 million people and a growth rate of 3.6% (1999). In 1985 it was estimated that 40% of households were living below the poverty line. The number went up after 1993 when the percentage of households living below the poverty line increased to 53% and 70% in 1997 (Debt Sustainability Document, 2000). In 1996, according to the World Bank, Rwanda's gross national product (GNP), at average prices of 1994-96, was estimated to be US $ 1,268 million, which is equivalent to $190 per head. It was recorded as one of the lowest in the world. It was also estimated that the GNP per head was decreasing at an average rate of 8.2% between 1990-1996, while GDP has decreased at a rate of 9.7% in 1990-1996 (Misser, 2000:924).

The recent history of poverty is closely related to the economic stagnation facing the country between 1986 and 1994, which primarily originated from the persisting stagnation of non oil commodity prices in the international market; poor economic policies adopted by the post independent governments and the frequent civil strife; the declining of agricultural productivity in the context of a growing population; and the impact of the genocide in 1994 which decimated the human resources base (Oxfam 1999).

Apart from the constant decline of GNP per capita between 1992 and 1996 from US $250 to US $205, social development continued to be an issue. Table 5 indicates that alongside the decline of GNP, the infant and child mortality figures were increasing. In 1992 the infant mortality rate was 85 infant deaths out of every 1000 births, while in 1996 the rate was 125 out of 1000; similarly the child mortality rate, which by 1992 was 141 children out of 1000, shot up in 1996 to 185 out of 1000.

Because of such structural imbalance, Rwandan government is entirely depended on foreign resources, mainly grants and debts.

2.5.2 Debts

Rwanda is among the highest indebted poor countries. By 1995 its outstanding foreign debts amounted to US $1 billion (Egboo 1997: 171). Like many other African countries, Rwanda borrowed heavily in the late 1970s and early 1980s. But the total amount of external debt rose rapidly after 1985, as regional recession and a collapse in world coffee prices hit the government's earnings (Oxfarm, 1999). Between 1985 and 1997 external debt more than doubled, from US $400 m to over US $1 bn. The Rwandan government also built up a large public domestic debt, reaching the equivalent of US $220 m in mid-1997.

Debts have been overshadowing the economic progress of the country by holding back the flow of revenues. According to World Bank statistics presented by Oxfam in Table 6, the net present value of debts in Rwanda by 1999 was 65% of GDP, while in terms of exports debts stand at 557%. At the same time government is spending 32% of GDP for debt servicing, which is 23% of government revenues.

2.5.3 Creditors

In common with other African countries the share of the multilateral creditors in Rwanda's external debt has steadily been raising, parallel to the increase of debt. Today, over 80% of Rwanda's debt is owed to multilateral creditors. By the end of 1997, US $947 m out of Rwanda's total external debt of US $1164 m, comprised arrears owed to multilateral creditors. About US $558 M was concessional debt owed to the International Development Association (IDA), the World Bank's 'soft loan' arm. 17% of the total external debt, equal to US $203 M, was owed to the African Development Bank (ADB). Only 16% of the total external debt is owed to bilateral creditors, and 6% to the Paris Club.

Table 5 Rwanda's deteriorating human development - 1992 and 1996

Indicator	1992	1996
GNP per capita (US $)	250	209
Infant mortality rate*	85	125
Child mortality rate*	141	185
Illiteracy - aged 10+ (%)	56	60
Severe wasting Of children- under-fives (%)	0.7	5.3

* (Per 10,000 live births) Source: UNICEF 1998, UNDP 1995

In descending order, the principal bilateral creditors at the end of 1995 were: France (US $54 m), Saudi Arabia (US $27 m), Kuwait (US $18 m), China (US $14 m) and Japan (US $14 m). Only US $18 m, less than 2% of the total amount, was owed to private creditors. In chapter one we saw that among of the factors for poor tax returns in Rwanda is lack of manufacturing and mineral sectors of production, meaning that the largest portion of taxpayers in Rwanda depend on primary sector of production, agriculture in particular.

Table 6 Rwanda's External debt indicators, 1999

GDP	**65%**
Net present value/exports	**557%**
Debt service/exports	**32%**
Debt service/government revenues	**23%**
Source: WB 1998	

2.6 PRIMARY SECTOR DEPENDENCE

The economic structure of Rwanda is dominated by the primary sector, which by definition is composed of the mining and agricultural sectors whose outputs are mainly for consumption. Agriculture is the largest sector of the economy in Rwanda. In terms of GDP, agriculture in 1989 was providing 40% of national GDP, while engaging about 93% of the economically active population. In 1994 agriculture was accounting for 51% of the national economy, employing more than 90% of the labor force and contributing 40% of foreign earnings (Rake 1999: 381). The industrial sector, including manufacturing and mining, has been contributing less. In 1988 the industrial sector was contributing 22% of the national GDP, from 17% in 1985, while employing 3% of the economically active population.

The service sector, which is the next largest sector in the country, was contributing about 34% of national GDP by 1988. In Africa Today (1991) it was observed that the manufacturing sector in Rwanda is the weakest section of economy, the reason among others is of low technology. It consists mainly of the processing of agricultural products and other consumer items, like beverages, matches, and soap for the small home market.

The agricultural sector for a period of 20 years has been contributing more than other sectors. Table 7 shows that in terms of GDP, in 1979 agriculture was contributing 53%, 43.3% in 1989, 47.4% in 1998, and 45.7% in 1999. In comparison, the industrial sector was contributing 20% in 1979, 18.7% in 1989, 21.2% in 1998, and 20.5% in 1999. Within the industrial sector manufacturing was contributing 14.0% in 1979, 11.2% in 1989, 13.0% in 1998, 11.7% in 1999 (World Bank 2000). Main products of manufacture were beer, lemonade, sugar, cigarettes, matches, soap, plastic shoes and blankets.

Rwanda is a country with limited natural resources such as mineral and oil. The main export commodities are coffee and tea, which are restrained by international prices. For example, in 1986 coffee accounted for 82% of Rwandan exports, but the prosperous nature of coffee exports in the1980s was drastically cut short by the international price in 1989 (Anderson 2000: 441). Actually, 99% of Rwanda's export economy depends on primary commodities: coffee, tea and tin. Pender, (1997) referred to the economy of Rwanda as has been utterly dependent on the fluctuations of commodity prices in the world markets.

Up to 1990, Rwanda was one of the weakest countries in the world, most vulnerable to the fluctuations of the world market, least able to control its own affairs, and increasingly dependent on the West. Even before the collapse of commodity prices, Rwanda obtained more income from aid than from its own exports.

Hyweghen (1999: 356) observes that the consumption driven Rwandan agriculture is providing no safety net for rural farmers in a monetary economy. For over a decade agricultural productivity has been declining due to the exhaustion of arable land, fragmentation, and the over-exploitation of available agricultural land owing to the rapid growth of the rural population, the degradation of the soil, lack of modern inputs and weak research and extension (ESAF policy paper, 1998).

Table 7 Structure of Rwandan Economy (%GDP)

	1979	1989	1998	1999
Agriculture	53.6	43.3	47.4	45.7
Industry	20.5	18.7	21.2	20.5
Manufacturing	14.0	11.2	13.2	11.7
Service	25.9	38.0	31.4	33.8
Private consumption	76.6	85.0	90.4	88.7
General government	13.1	12.7	11.3	12.7
Imports of goods and services	22.8	17.3	22.9	21.1

Source: World Bank 9/9/00

2.7 COMPOSITION OF THE TAX SYSTEM

The tax system in Rwanda is divided into four main regimes: income tax, property tax, and taxes on sales and goods and international trade. Between 1978-80, the total income tax was standing at 11.13% of GDP, while taxes on goods and services were at 2.12%, taxes on foreign trade 3.18%, and property tax was 0.15% (Tanzi, 1987). Of the total tax revenue, the share of income taxes was 19.5% in 1978, while taxes on goods and sales were contributing 19.21%, foreign trade 54.23%, and property tax 1.10% (Tanzi 1987: 212).

As is shown in Table 8, in recent years taxes on goods and services as well as on foreign trade continued to dominate the tax structure. In 1993, out of the total tax revenue of 23.9 billion (RWF), taxes on income and profit were 5.9 billion, while taxes on goods and services were 10.3 billion, foreign trade taxes and other taxes were 7.2 billion, while property taxes were 0.5 million. In 1994, when the total tax revenue was 6.0 billion (RWF), taxes on income and profits were 1.5 billion (RWF), taxes on goods and services 2.3 billion (RWF), foreign trade taxes 2.2 billion and property tax 0.1 billion (IMF No. 98/115).

In 1995 total tax revenue was 21.7 billion (RWF), taxes on goods and services were 9.9 billion (RWF), while taxes from international trade increased from 7.2 billion (RWF) in 1993 to 8.9 billion in 1995 (table 8). According to the above configuration of the Rwandan tax structure the contribution of income tax regimes, continued to be less visible in the composition of tax revenue in Rwanda. Likewise tax bases within the income tax structure - individual and corporate taxes, maintained fluctuating disparities.

From the base years of 1978 and 1980, taxes from income and profits were making 2.7% of GDP, but out of this individual income taxation was contributing 0.2% while company taxes were contributing 1.24% (Tanzi, 1987). In the 1990s the contribution of company taxes was fluctuating, in 1993 out of total income tax revenue of 1.5 billion, company's tax was contributing 0.7, while individual tax contributed 0.4.

In 1995 revenue from individual taxes outdid the revenue raised through company taxes by more than half, contributing 1.6 billion (RWF) to the total income tax revenue of 2.8 billion (RWF), while company taxes were contributing 0.8 billion (see table 8). In 1996 individual taxation figures started decreasing; out of the total income tax of 10.0 billion, company's taxes contributed 6.6 billion RWF, while individual taxes were only contributing 2.7 billion. Similarly in 1997, company's taxes were contributing more than half of the total income tax, which amounted to 14.2 billion RWF. During this time corporate taxes were contributing 9.3 billion RWF, while individual taxation was providing only 4.3 billion RWF.

Table 8 Receipts, 1993-1997 (in Billions of Rwandan Francs)

	1993	1994	1995	1996	1997(est)
Total revenue	25.9	6.0	23.1	39.4	58.1
Total tax revenue	23.9	6.0	21.7	36.2	54.9
Taxes on income and profit	5.9	1.5	2.8	10.0	14.2
Companies	2.5	0.7	0.8	6.6	9.3
Individuals	2.1	0.4	1.6	2.7	4.3
Others	1.3	0.3	0.3	0.8	0.6
Property taxes	0.5	0.1	0.1	0.3	0.4
Taxes on goods and services	10.3	2.3	9.9	14.4	21.9
Excise taxes	5.9	1.1	5.7	7.9	12.3
Turnover taxes	2.8	1.0	3.0	5.0	7.5
Road fund	1.6	0.0	1.2	1.4	2.1
Taxes on international trade	7.2	2.2	8.9	11.5	18.9
Import taxes	7.0	1.8	6.9	10.7	13.5
Export taxes	0.0	0.1	1.8	0.3	4.3
Other taxes on international trade	0.2	0.3	0.3	0.5	0.8
Non-tax revenue	2.0	0.0	1.4	3.2	3.1
Grants	18.1	1.5	38.4	31.4	41.6

Source: IMF, NO. 98/115

Two situations need to be notified here, as far tax system reform in Rwanda is concerned; first, there has been poor tax administration that originated basically from the poor performance of public sector management. The second situation is that poor economic outputs limits the creation of a tax paying community. In other words the nature of economic structure dominated by poverty and rural agriculture creates low tax morale among the Rwandan people. Implicitly therefore tax system reform in Rwanda has to go concurrently with public management reforms and economic structural reform to transform the rural population into viable economic community, thus tax paying community.

2.8 CONCLUSIONS

The chapter reflected on those administrative and political situations that have either influenced or affected the implementation of tax reform policy in Rwanda. But the most important aspect revealed in this chapter, is that the problems of the tax system in Rwanda have historical roots, mainly in economic development and the political organization of tax administration. Tax administration in Rwanda is a colonial invention, introduced into a primitive and traditional system of production and incompetent colonial administration. The post-colonial governments inherited this legacy of substandard tax administration.

In this chapter, it was also revealed that historical failure of the tax system in Rwanda has been constantly manifested in a continuous budget deficit. In fact, in this chapter the budget deficit was shown to be the result of the failure of the tax system. The chapter also reflected extensively on structural factors that dominated the Rwandan socio-economic situation. They not only had a major impact on the development of an effective tax system, but reforming the tax system was also a way of resolving them.

Briefly, despite the genocide effects presented as episodic events with respect to the tax system, the remaining tax system problems in Rwanda are economic and institutional. The significant point to note, however, is that the performance of the tax system is a multifaceted process, so the reform of the tax system for better performance needs also to be a multifaceted process, including economic and institutional reforms. In the next chapter we are going to look at normative requirements for tax system reform.

CHAPTER 3: NORMATIVE REQUIREMENTS FOR A TAX SYSTEM

3.1 INTRODUCTION

Chapter 1 provided an introduction to the research, and traced out the research problem, hypothesis, the methodology and theoretical framework of the research. Chapter 2 underlined institutional, economic and political factors that influenced or affected the tax reform process in Rwanda. Chapter 3 explores the normative requirements for a tax system by addressing the following issues:

Theories of Taxation, including concepts such as **Taxation and Political Systems, Allocation of Resources** and **The Philosophy of Public Goods**. Issues such as **Democratic Values** in a tax system, the **Quality of the Public Sector** in tax administration, **Properties of a Good Tax System** and **Types of Taxes** are dealt with. The chapter also examines technical issues concerning an **Efficient and Effective** tax system, **Tax Administration and Compliance, Reform of Tax Administration, Privatisation of Tax Administration,** and Tax Structure and Administration in **Developing Countries,** followed by a **Conclusion.**

3.2 THEORIES OF TAXATION

Taxation is a multidisciplinary field of study. For the last 300 years, taxation has been at the centre of varied academic interest, from public economics and public finance, to public administration and political science. Insights from other social science disciplines such as sociology, psychology and the humanities have made an imminent contribution to modernising tax administration.

Nevertheless, the four canons of taxation – equity, efficiency, certainty, and convenience – postulated by Adam Smith in 1776, have continued to be the building blocks in the study and practice of tax administration.

Taxation is as old as the state. *"And it came in those days, that there went out a decree from Caesar Augustus, that the entire world should be taxed"* (Luke ii: 1). And the whole world has in fact been rendering unto Caesar ever since (Nobes & James 1997/98: 1).

There are different views on the concept of taxation. Taxation is considered either to be a relationship between politics and economics, or an interventional facility for the government to keep an upper hand in the economy. Likewise taxation in some quarters is regarded as an act of government to drain resources from the people, while other analysts like Wagner (1991: 14) refer to taxation as a contractual relationship between government and citizen.

The varied conceptualisations of the tax phenomenon extend to different contexts, but the thrust of all of them has a bearing on the relationship between three pillars: people (citizen or taxpayer), resources (economy) and government.

"Taxation is a compelling phenomenon, precisely because it is where the politics meets the economics. The way in which national taxes create incentives, the way in which political and economic life becomes organized" (Bates in Gillis 1989:487).

3.2.1 Classifications and Definitions

According to Sommerfield (1980: 1), tax can be meaningfully defined as any non-penal yet compulsory transfer of resources from the private sector to the public sector, levied on the basis of predetermined criteria and without reference to the specific benefits received in order to accomplish some of the national social, political and economic objectives.

Nobes and James (1997/98: 10) expand on this definition with their view that tax is a compulsory levy made by public authorities for which nothing is received directly in return. Benjamin Franklin wrote in 1789: "In this world nothing can be said to be certain except death and taxes", and that "Taxes are transfers of resources from person or economic unit to government and are compulsory or legally enforced" (Cohen & Cohen in Black et al, 1999: 114). All in all, there continues to be rifting debate on taxation, whether to classify taxation as **penal** or **non-penal**, as a **compulsory responsibility** or **a confiscation**.

Sommerfeld *et al* (1980:5) expound on the debate by pointing out that tax payment is compulsory in the sense that it is a transfer of resources without prior assent of the taxpayer, and without specific and roughly equivalent benefits. This is in contrast with private transfer that is performed through an agreed form of exchange between the supplier and consumer of a commodity. Principally taxes are used for purchasing public goods. This power of compulsion is restricted to the public sector of a sovereign government.

In modern economics taxation is the method used by the government to divert resources away from individual citizens to the control of the government. However, Sommerfeld *et al* distinguished it from outright confiscation because of taxing principles, which are a set of criteria that have to be met before taxing can commence. The common understanding is that these criteria will fall within the limits of equality, and will provide the desired result. The most direct method of transferring resources from the private sector to the public sector would be the outright confiscation of wealth. This method has been used exclusively during wars and political chaos.

The two elements, confiscation and compulsory responsibility, highlight the mutual relationship between public and private resources. While confiscation takes away private resources by direct means in a crisis, taxation diverts private resources to the public sector indirectly and by means of a peaceful process. Obviously both lead to the decrease of wealth among private citizens and a corresponding increase in the wealth of the state (Sommerfeld *et al* 1980: 6). Other means of transferring resources from the private sector to the public sector include beneficiary charges, government bonds and inflation.

3.2.2 Objectives of Taxation

Taxation is the responsibility of the state. In other words, from the above definitions and explanations taxation is shown to be the process of a material relationship between the state and its institutions and the citizen. According to Sommerfeld *et al* (1980), there are five reasons why citizen should pay tax: for raising revenue for the government; insuring price stability through inflation and government purchase; economic growth; eeconomic development by promoting savings and investment; as well as wealth redistribution.

3.2.3 Four Canons of Taxation

Adam Smith (1776), in his book *The Wealth of Nations* (Book V, Chapter II (www.worldbank.org) provided the basic principles of taxation, sometimes called the four canons of taxation: Before I enter upon the examination of particular taxes, it is necessary to premise the four following maxims with regard to taxes in general.

> *I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.*

II. The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. A tax upon the rent of land or of houses, payable at the same term at which such rents are usually paid, is levied at the time when it is most likely to be convenient for the contributor to pay; or, when he is most likely to have where to pay.

IV. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business, which might give maintenance, and unemployment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds, which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals. An injudicious tax offers a great temptation to smuggling. But the penalties of smuggling must rise in proportion to the temptation. The law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it; and it commonly enhances the punishment, too, in proportion to the very circumstance that ought certainly to alleviate it, the temptation to commit the crime. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, *vexation, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it. It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign.*

These four maxims of taxation have been the guiding principles for designing and reforming tax systems. From these maxims, the former World Bank Senior Economist, Stiglitz (1980) derived four characteristics of a good tax system:

- **Economic efficiency**: The tax should not prevent efficient allocation of resources.
- **Administrative simplicity:** The tax should be easy and inexpensive to administer.
- **Flexibility:** The tax system should respond easily to changes in economic conditions.
- **Transparency**: Individuals should be able to ascertain their tax burdens so that burdens can be politically tailored to what society considers desirable.

3.3 TAX SYSTEM AND STATE

In modern communities governments are accepted to be the only institutions that collect taxes; it is done in return for rendering collective services to the community (Gildenhuys, 1993: 211). By and large, taxation is an essential source of finance for the government if is to be able to discharge its responsibility of providing service to its citizens. Tanzi & Zee (2001) remarked that *"until someone comes with a better idea, taxation is the only practical means of raising revenue to finance government spending on goods and services that most of us demand".*

The more provision is made for public goods and services, the higher government expenditure is, and therefore the more taxes government needs to raise either directly or indirectly. Needless to say, this is an unwelcome gesture to the taxpayers, as it reduces private spending (Nobes & James 1997/1998:7). However, governments still have other means of transferring resources from the people without going to taxation. These other means include the debasement of the currency through the production of too much money. This is fiscal manipulation that leads to the decline of the value of money, thus reducing the purchasing power of the private sector while in the meantime increasing the financial capacity of the public sector. Government can also transfer resources from the private consumer by commercialising some of its services (Nobes & James 1997/98: 8).

According to Rosen (1999), taxation and the provision of public services constitute a public process that raises mixed feelings. These feelings are typical of and inextricably bound up with the taxing and spending activities of the government. In biblical times, the prophet Samuel in 1030 B.C. resisted the appointment of a king for Israel in spite of the people's request, because of his concerns about the expenditure that would be incurred to maintain the government.

"This will be the manner that the king shall reign over you. He will take your sons and appoint them unto him, for his chariots and to be his horsemen and shall run before his chariots ... . And he will take your daughter to be his performers and to be cooks and to be bakers. And he will take your fields and Vineyards, and Oliveyard, even the best of them and give to his servants... He will take the tenth of flocks, and ye shall be his servants. And ye shall cry out of that days because your king ye shall have chosen" (1 Samuel 8: 11-18, in Rosen 1999:1).

Samuel's objections were rejected by the Israelites. *"Nay; there shall be king over us; and that our king may judge us, and go out before us, and fight our battles"* (1 Samuel 19-20). The Israelites wanted a government that could collect taxes and at the same time be capable of providing a collective service. Samuel's position versus that of the subjects presents mixed feelings about taxation. Essentially, the subjects recognized the importance of having a government that could take responsibility on their behalf, and therefore the necessity for them (subjects) to pay taxes to enable the government to meet its responsibilities. On the other hand Samuel, a member of the intelligentsia of that community, gives the impression that the existence of a government to whom taxes are paid amounts to exploiting the citizens (subjects).

The fundamental notion here is the political dynamics of taxation, governance and service delivery. Though technically there is no direct return on paying tax, the taxpayer knows that the indirect result of paying tax is to finance the government, which principally can represent the people, provide justice, and lead the people to the battle. Paying tax is legitimation of government. If people were not prepared to pay tax, government as an institution would not be able to exist. That is why Samuel had to caution the Israelites that since they accepted having a government, they had to be prepared also to pay tax. The debate between Samuel and the Israelites connotes the implications of tax compliance and the role citizens have in building the political system of a country.

3.3.1 Taxation and Political System Performance

Taxing and providing services are a source of legitimacy that a political system enjoys. According to Heywood (1997: 19), a political system is a complex, interrelated and interdependent set of activities between government and citizens. Politics is a broader concept both in application and in theory. But in a simplified way Heywood defined politics as human and academic activity shaped by conflict and cooperation. "Human society is characterized by people with rival opinions, different wants and competing interest, which are likely to disrupt the rules of living together, while still need to live together". Augmenting this principle, Heywood (1997:4) notes that politics is developed as a neutral force to arbitrate for the interest of rules of living together.

A political system is exemplified by the process of interaction between system capacity (government institutions) and citizens' effectiveness (participation). Political theorists have recognized that there are two sources of conflict in society; namely system capacity and citizen's effectiveness (Dahl & Tufte 1973: 137). According to Dahl and Tufte, system capacity means the institutional capacity of the government to deliver public goods such as laws, allocate public resources, collect taxes, and do other things aimed at meeting the needs of the citizens.

The Elton Mayo model of inputs and outputs (Heywood 1997:11) simulates this process. Provision of public goods and service is an output of the government that is processed by the public institutions from the citizen inputs. The citizens' inputs include public demands, and support of the citizens for the government through paying tax and complying with the demands of their public responsibilities. Citizen demands vary from welfare issues to economic and social infrastructure, as well as to sound policies. However, achieving *citizen effectiveness* goes beyond the provision of public needs to entail also the participation of citizens in the decision-making process (Dahl & Tufte 1973: 5).

Almond and Bingham (1978: 303-305) include in the performance of a political system the effective implementation of three main objectives of taxation. According to these two scholars a political system will be judged with reference to its capacity to extract resources; distribute wealth; and lastly having the capacity to regulate the economy.

Taxation and taxes, according to Fox (1999: 103) enable the government to perform its economic, political and social functions. Taxation enables the government to meet the three main and distinct policy objectives of allocation, distribution and stabilization. In the same vein Nobes and James (1997/98:8) state that taxation enables the government to facilitate the allocation of economic resources, creating a way for equal and just redistribution of wealth, and maintaining economic stability in the country.

3.3.2.Allocation of Resources

The allocation function of government according to Fox, relates to the process of securing the efficient provision of social goods (public goods and services), (Nobes & James, 1997/98, Gildenhuys, 1993, and Rosen 1999). Contrary to private goods social goods are not acquired through market transactions. Social goods can be defined as goods that are regarded as socially valuable to and benefiting all consumers. The allocation function means the distribution and redistribution of resources in the country.

A tax system is one of the methods used by the government to distribute incomes and wealth, in lieu of the market. Through market mechanisms individual income and wealth are determined by market values (demand and supply). To put it differently, in a market system the distribution of income will occur among those who have something to exchange in the market. Therefore people without land and without capital, unemployed, destitute and other groups of have-nots, are taken care of by the government. So, by taxing the rich government becomes able to supply public goods and services to those who cannot obtain these things through market competition, thus making for an equitable distribution of wealth (Nobes 1997/98: 10).

Gildenhuys (1993: 218) finds the redistribution function an implicit and deliberate government policy for balancing the poor and the wealthier in an economic society through taxation. When more tax is collected from one taxpayer than from another, and both receive the value of the collective services equal to the per capita cost of rendering such services, then redistribution of wealth automatically takes place.

The redistribution policy is a significant function as it helps to determine the tax structure and at the same time it helps the tax authority to deal with issues of horizontal and vertical equity in a tax system. Wealth differentiation is a common phenomenon in any community, but Musgrave (1984) as quoted by Gildenhuys (1993:217), identifies some fiscal means that are used by government to balance the situation:

1. A tax transfer scheme combined with a subsidy to low-income households.
2. A program whereby the income tax is used to finance public services especially those such as public housing, which particularly benefits the low-income households.
3. A combination of taxes on goods purchased by high-income consumers with subsidies to other goods that are used chiefly by the low- income consumers.

Fox (1999: 104) regards the redistribution policy as an economic function, which is usually performed by the market, but not successfully. The market principles provide that change in economic conditions can improve the position of an individual in society while it is not to the detriment of another person's position, which is of course an indication of market efficiency. However, Fox concludes that the market approach does little to solve the basic social issues of distribution and redistribution.

The redistribution of wealth is an unavoidable responsibility of governments to ensure equality in society. Todaro (1994: 41-42) observes that all nations should have an equal distribution of wealth, but while people have a right to their endowments this distribution should be arranged to maximize happiness or should meet a certain standard of equity.

"There are large disparities between the income of the rich and poor and in both developed and undeveloped countries. Nevertheless, the gap between the poor and rich is generally greater in undeveloped countries than in developed countries" (Todaro in Fox 1999: 104).

Fox (1999) and Gildenhuys (1993) both discuss devices for balancing the wealth and income in a society, namely, transfer through income tax schemes, use of progressive income tax to finance public services, and using taxes on goods purchased largely by high-income consumers to subsidize goods mainly used by low-income households. But Gildenhuys (1999: 219) decries the fact that redistribution policies do not meet the needs of target groups because of poor implementation. He notes that the underlying problem of policy implementation is that fiscal policy benefits do not always reach their target groups because of the abundant administrative cost that absorbs a big portion of the benefits.

3.3.3 Stabilisation

Maintaining stabilisation is another reason that a government intervenes directly in the economy through taxation. Nobes and James (1997/98:108) identify two ways through which governments have been influencing the economy. One is through fiscal policy and another is through monetary policy. Fiscal policy refers to maintaining the balance between government expenditure and income, which includes taxation as the main source of income for the government, while monitory policies are normally conducted through the supply of money in the economy. Government applies fiscal and monitory policies to stabilise the economy in terms of ensuring the employment of all factors of production in the country and at the same times securing stability of prices (Nobes & James, 1999: 10).

In short government collects tax as deliberate policy of generating revenue in order to be able to supply goods and services to the citizens. In the next section we are going to examine what public goods entail and the relationship between this concept, the government and taxes.

3.4 THE PHILOSOPHY OF PUBLIC GOODS

Government intervenes in the market to facilitate the provision of public goods. Adam Smith (1776) accentuated the fact that markets are unlikely to provide public goods because they don't provide a direct profit.

"[*Government has] the duty of erecting and maintaining public works and certain public institutions, which can never be for the interest of individual neither for small number of individuals, to erect and maintain; because their profit could never repay the expenses to any individual or to any small number of individuals, though it may do much more than repay to great society* (Nobes & James1997/98: 9).

There are two fundamental principles in the allocation of public goods and services. Firstly, individual persons cannot be excluded from consuming public goods, even if they are not able to pay for them. The second principle is that the private sector and market cannot provide pure public goods, basically, because a neutral consumption relationship exists, in which individual preferences or biases do not matter. Furthermore, consumption of public goods is the inherent right of every citizen (Nobes & James 1997/98:9).

The provision of public goods is deeply entrenched within the framework of the policy relationship between the government and citizens, which implies that the government has the authority and the right to draw resources from the citizens (taxpayers) with the intent of providing public goods. Yet this model of demand and supply does not entail that the functional allocation of public goods can be simulated by market mechanisms. Pope John XIII equated the provision of public goods with a moral obligation that the government has:

"There exists an intrinsic connection between the common good on one hand and the function of public authority on the other. The moral order which needs the public authority in providing the common goods in human society, requires also the authority to be effective in attaining that end" (in Rosen 1999: 61).

Different authors put public goods in different categories, namely **pure public goods** and **impure ones.** Put simply, Rosen (1999: 61) defines pure public goods as non-rival and non-excludable goods that have no additional cost whatsoever for another consumer. Such goods include roads and sanitation. Compared to this are the impure and excludable public goods, which are also bound to the market principle of competition.

There are instances of private sector involvement in providing public goods. For example, the protection of personal property is the responsibility of government, but today it is commonly found that private security companies are engaged in providing security services to individuals and their properties, in addition to the government's involvement in this service. Thus the private and public sector are in partnership in providing services.

Tax collection and allocation of public goods and services are political processes by and large, so the government is challenged to observe basic democratic principles. In the next section we explore taxation on the basis of this challenge.

3.5 DEMOCRATIC VALUES OF TAX SYSTEMS

Some puzzling issues emanate from a logical interpretation of the allocation function. Usually allocation is referred to as a revenue function. From an orthodox view, taxes are mainly levied to cover the cost of collective services. Nonetheless taxpayers cannot determine the amount of tax to be paid, nor decide on the type of services to be given to them (Gildenhuys, 1993:215).

Public goods are financed from the government budget, which is made up from the taxes received from the citizens. Fox (1999:104) challenges the unilateralism of the government in the allocation of public goods, maintaining that collecting taxes from the people must go hand in hand with an approach where supplying social goods and the cost of their allocation should be determined by the consumer, or else voluntary taxation will be at a risk.

Musgrave (1959:16-17) regards the allocation of public goods as an interaction between taxation and expenditure. He notes that the primary challenge is that allocation and budget must be balanced. The amount of resources (taxes) transferred from private pockets must be equal to the amount of resources added to the public use.

The ideal concept of empowering taxpayers to play a role in decisions on what they receive and the expenditure of the government needs to be sustained by the effective existence of democratic values in a public financial system. Democratic values in public resource management include elements such as representation, responsiveness, transparency, legitimacy and public accountability (Schewlla *et al,* 1999: 15). All of these elements have important implications in public resource management, but most significant is public accountability. This entails that the actions of public organisations are subject to public scrutiny, to encourage debate and public criticism. According to Schwella *et al (1999*: 16), representative institutions and news media should lead the debate. This will empower legislative institutions to exercise control over the government on behalf of citizens.

Brinkerhoff and Goldsmith (2001) observe that the democratic representation of taxpayers in the public financial system is possible through the participation of civil society organisations (CSOs) in fiscal policy. Fiscal policy relies heavily upon an influx of resources from taxes. Having a tax system that people accept, if not wholeheartedly embrace, and that functions both effectively and fairly, is important to encourage tax compliance and an ongoing flow of financial resources to government coffers. In many developing and transitioning economies, however, citizens' perceptions, attitudes, and behaviors regarding taxes result in widespread non-compliance and evasion. For example, the post-apartheid government in South Africa is facing significant problems with non-compliance. Before coming to power, the African National Congress encouraged its supporters to refuse payment of water and utility charges as a means of contesting the legitimacy of the state-sponsored black local authorities. Now the ANC faces the challenge of reversing a "culture of nonpayment" for municipal services among township residents. The resulting arrears pose a major financial burden on all levels of government (Brinkerhoff & Goldsmith 2001).

Taxation is a facet of macroeconomic policy that is relatively easy for the layperson to grasp. While ordinary people encounter monetary policy only indirectly, they are likely to have had immediate experience of public revenue agencies, and may have developed strong opinions about taxes. This may make it easier for CSOs to marshal their members to follow and influence tax policy.

Civil society organisations in developing countries are therefore taking an increased interest in tax reform. Because fiscal policy is so intimately connected with who gets what, which is one classic definition of politics, the configuration of contextual factors and the range and relative positions of interest groups are highly influential in shaping the opportunities and outcomes of participation.

In 1994, for example, the Freedom from Debt Coalition in the Philippines launched a national tax campaign, focused on making the tax system more progressive. The campaign proposed tax exemptions for low-income groups, tax incentives for small and medium enterprises, and limitations on deductible expenses for corporations. These proposals, however, never entered the political mainstream—a problem often encountered by groups that claim to speak for the poor. Even though the Philippines gets high marks for democratisation since the fall of the Marcos regime in 1986, that has not ended the hegemony of private fortunes and large, family-owned business monopolies. The national tax campaign had no noticeable effect on the Philippines Comprehensive Tax Reform Program enacted in 1997 with the support of international financial institutions.

Fiscal policy determines the way governments manage revenues, expenditures, and debt. Civic involvement on the revenue side principally concerns the level and structure of taxes—who pays and how much. On the expenditure side, civic involvement focuses on: 1) priorities for public spending—who gets what services, and how generously are those services; and 2) efficiency, effectiveness, and equity issues related to spending for services. The relationship between revenue and expenditure is critical, for it determines the fiscal surplus or shortfall—which in turn affects overall macroeconomic stability. The involvement of civic organisations in matters of government revenues and expenditure provides an opportunity for taxpayers to participate in the process.

3.5.1 Tax payers' participation

The two scholars Brinkerhoff and Goldsmith (2001) suggest two ways of enabling the participation of taxpayers: information sharing and consultation. Most of the opportunities for participation in fiscal policy exist at the levels of information sharing and consultation. Within the category of expenditure policy, an important opportunity exists for collaboration and empowerment through service delivery satisfaction surveys and/or budget monitoring.

3.5.1.1 Sharing of information

Sharing information with taxpayers is an important way for governments to convince the population of the social benefits associated with tax payments. Information is critical to allowing civil society to attain higher levels of participation, because it provides the knowledge base for citizens and CSOs to influence policy makers to make the tax system fairer, cheaper to administer, and/or more effective. Tax authorities are often a primary target for administrative reforms to enhance the customer orientation of the public service.

3.5.1.2.Consultation

Brinkerhoff and Goldsmith (2001) suggest that there should be deliberate consultation and collaboration between government and the civil society in implementing tax reforms. Overhauling the tax system has many implications for low-income groups. Tax reform may lead to a reduction in government revenue, an increase in revenue, or a shift to new sources of taxation with no net effect on revenue. In addition, reform often seeks to redress imbalances between relatively better-off and worse-off societal groups via redistributive revenue measures. To handle these difficult tax issues consultation and collaboration among the stakeholders (government, taxpayers and the civil society) are required to find the balance between maintaining adequate funding for important government programs, assuring some minimum level of compliance, and providing sufficient incentives to private investment, while avoiding placing an undue burden on poor people.

Whatever the specifics, tax policy is prone to attract political controversy because it invariably creates self-aware winners and losers (stakeholders whose tax liability drops and others whose liability goes up). Tax reform is one of the fiscal policy "battlefields" on which "wars of attrition" over monetary and fiscal policy change are fought between societal groups with conflicting interests. While public sector officials might prefer to avoid such conflicts, serious tax reforms invariably produce controversy. Civil society participation can help resolve these battles.

For example, Australia wrestled for years to find a better way to raise public revenue, but the debate floundered over whether to shift to a broad-based consumption tax. A civil society forum in 1996, the National Tax Reform Summit, was instrumental in moving the debate forward, demonstrating that participatory processes can facilitate "tough" decisions. The gridlock broken, Parliament soon voted for a New Tax System that took effect in 2000 (Brinkerhoff & Goldsmith 2001).

This suggests that, for many countries, the first steps for increasing participation in tax policy need to focus on information dissemination and transparency regarding existing tax procedures. Such an approach involves several targets. **First**, it means encouraging tax authorities to pay closer attention to their relations with citizens, and engage in a more systematic and broader outreach. Most public sector reform programs already do this (including those in the United States where the IRS has been singled out for improvement along these lines). **Second**, it includes capacity building in the media to raise the quality of reporting on tax issues. **Third**, it aims to selectively strengthen the advocacy of CSOs that have an existing or nascent interest in tax policy. Most 'poor' countries are unlikely to have single-issue advocacy groups devoted to tax issues, as found in OECD countries. Still, tax issues can be taken on by organisations that have a broader economic policy agenda, such as DISHA in India or the Institute for Democracy in South Africa (IDASA).

3.5.2 Participation in Expenditure Policy

The participation of taxpayers is not restricted to the receipts side of public finance but can involve the expenditure side as well. Brinkerhoff and Goldsmith (2001) point out that government spending is the flipside of tax policy, and participation on this issue mirrors participation on the levying of taxes. Once again, the composition of the budget affects low-income people directly. They tend in most countries to be heavy users of government social services, and service delivery inefficiencies, skewed distribution of services, or cutbacks in service levels can have an immediate and negative impact on them. The overall level of public spending also affects them, but usually more indirectly through impacts on macroeconomic aggregates.

Governments in developing and transitioning countries typically have to walk a budgetary tightrope, and the well-documented experience with structural adjustment demonstrates the problems, tensions, and pitfalls of maintaining this balancing act. Because governments everywhere need the support of their constituents to remain in power, there is a universal tendency to spend more rather than less to assure support and popularity. HIPC country governments have little choice but to cut down on what they spend, although it is difficult to determine where cuts should be made. Public officials face resistance from all groups that bear the brunt of fiscal discipline—whether that be government workers whose pay is cut, businesses that lose tariff protection and other subsidies, or rural producers who have to pay international market prices for agricultural inputs. While technical arguments enter into the debate, ultimately political bargaining will resolve the question of which groups make which sacrifices.

Because fiscal policy is so politically charged, governments have tended to manage the policy process by seeking to insulate policy makers from outside pressures. From the point of view of government, opening the budget debate to increased popular input raises three main concerns: a) participation will discourage fiscal discipline; b) it will raise citizens' expectations regarding resource allocation and subject government to demands it cannot meet; and c) it will set off conflictual, divisive, and potentially destabilising political dynamics. While in some cases these fears may be valid, evidence exists to suggest that they may be overstated. At the very least, there are approaches and tools, many of which are already being used in Participatory Poverty Assessments (PPAs) and Country Assistance

Strategies, to help offset the potentially negative impact that participation can have (Brinkerhoff & Goldsmith 2001).

A tax system is part of the public sector. In fact, to put it differently, taxes are a public institution, and therefore the quality of the public sector depends on the quality of the tax system. The next section covers the relationship between a tax system and the quality of the public sector.

3.6 TAX SYSTEMS AND QUALITY OF THE PUBLIC SECTOR

A high quality public sector requires an efficient tax system, and an expenditure system that minimizes inefficient and unproductive spending (Tanzi 2000:4). According to Tanzi implementing public policies is only possible if resources are raised through taxation. Thus there is a need for an appropriate system to collect taxes. And, of course, there is a need for institutions that will spend the money and keep track of that spending.

Taxation is a traditional institution of the state. The state fulfils its role through the set of rules, laws, and institutions that guide and make up the public sector (Tanzi 2000: 7). The higher the quality of the public sector, the easier it will be for the state to fulfil its role. By the quality of the public sector is meant here the characteristics that allow the state to pursue its objectives in the most efficient way. Although it is difficult to separate the two, the quality of the public sector is not necessarily the same thing as the quality of economic policy. A high quality public sector is simply the instrument that facilitates the formulation and the implementation of the government's policies. A good public sector makes it easier for the government to pursue good policies. But, even a high-quality public sector cannot guarantee consistently good economic policies because it cannot prevent policy makers from occasionally pursuing poor policies.

However, one would hesitate to say that a country's public sector is of a high quality if poor policies are frequently pursued, and one would expect to find a high correlation between the qualities of the public sector, as defined here, and the quality of economic policy. In other words, over time a high quality public sector is likely to promote good policies and a low quality public sector is likely to promote poor policies. The quality of the public sector is signified by the quality of public institutions.

3.6.1 Quality of public institutions

The quality of the public sector may be adversely affected by the absence of some essential institutions, or by the poor performance of the existing institutions. For example, in may countries, there are no institutions responsible for enforcing competition or for forcing full disclosure on the part of financial institutions, or for requiring the publication of good accounts on the part of enterprises whose shares are traded in the stock market. As a consequence the market may function less well because of cronyism and monopoly powers or because of lack of essential information.

The performance of public institutions depends on many factors including (a) tradition and reputation; (b) the resources they have available and the discretion over their use; (c) the clarity of their mandate; (d) their organizations; (e) the incentives that they face; (f) the quality of their leadership and staff; and (g) the freedom they have over organisational matters (Tanzi 2000:10).

Tax administration is one fundamental example of such institutions. Its performance will depend, in part, on its tradition and its reputation. A tax administration that has been efficient, honest, and proud in the past is likely to continue to be so in the future unless it faces truly fundamental shocks. By the same token it is very difficult in the short run to change a corrupt and inefficient administration. Its performance will also depend on the resources that it has available to hire capable employees and to pay good salaries, to invest in new computer technology, to carry out necessary audits and so on. The clarity of its mandate – for example, to enforce fairly and objectively the tax laws – is important. Its day-to-day independence from political pressures is essential.

Tanzi (1995:15) acknowledges that when the mandate becomes unclear, either because the laws are not transparent or because the institution is subjected to political interference that forces it to accommodate the special circumstances of some taxpayers, problems develop. This, for example, has been the case in some transition economies and in some developing countries.

In these countries, according to Tanzi (1995:18), political interference has reduced the quality of the tax administration. The organisation of the tax administration is also important and so is the set of incentives that it faces. If an institution is poorly organised, or if good or bad performances are compensated equally, the contribution of this institution to the quality of the public sector will be low.

There are current attempts to strengthen incentives by making tax administration politically independent like central banks, and by negotiating explicit contracts between the government and the tax administration that require quantitatively specified performances. In Australia, for example, the government guarantees that the tax administration will receive a given level of resources over a three-year-period. In exchange the tax administration commits itself to delivering specified outcomes and some quantified outputs.

A discussion on enforcement mechanisms and control would not be complete if two fundamental points were not made. The first is the weakness of the cash accounting approach that has traditionally characterized the measuring of the operation of the government, in providing support for efficiency controls. The second is the developing field of measuring consumer reaction and preferences with respect to the services rendered by public agencies. Before addressing these two points, it is important to mention that any concept of quality of government services must be related to the cost of those services and to the resources available to deliver them. The more resources that are available, the better the quality that one could expect public services to have.

To insure the implementation of tax reform policies, there must be concurrent reform in the public sector aimed at creating public institutions of high quality that are capable of policy implementation and tax collection as well as public resource management. Essentially, high quality in the public sector with regard to the implementation of tax reforms must reflect new values in public resource management. These values include public entrepreneurship, accountability, transparency, representation, efficiency and effective management. Moral and administrative values such as social equity, rule of law and a culture of constitutionalism are also paramount (Schwella *et al*, 1999: 16-17). Quality public institutions in tax administration therefore exemplify a good tax system. We review the characteristics of good taxation below.

3.7 PROPERTIES OF GOOD TAXATION

Adam Smith is one of the pre-industrial tax analysts who by 1776 had defined four qualities of taxation, namely, equity, certainty, convenience and efficiency. The idea is that each tax system should be scrutinized on the basis of these four principles (Nobes & James 1997/98: 17).

Black et al (1999: 118) have in turn identified the following four properties of 'good tax': it is equitable, economically efficient, administratively efficient, and flexible. The authors regard these four properties as the criteria for designing any tax system. In other words there can be different tax systems, which are amended over time, but the evaluating standard will always be whether the particular tax system is founded on the pillars of promoting the fair and equitable treatment of all taxpayers, is shaped in a way that does not distort economic behavior, is administratively less costly in terms of enforcement and compliance, and is flexible enough to reflect the dynamic characteristics of the economy.

3.7.1 Equity

Equity is an evaluating indicator of whether the tax burden is being shared fairly in the society (Gildenhuys 1993: 224). Tax analysts have designed some principles to evaluate the principle of equity. Prominent are the **ability to pay principle** followed by the **benefit principle**. Adam Smith (1776), as quoted in Black et al (1999:119), said of the responsibility to pay tax, that *"The subjects of every state ought to contribute towards the support of the government as nearly is possible to their respective abilities, that is in proportion to the revenue which they respectively enjoy under protection of state"*.

Equity is a common term in political and humanistic studies, but the thrust of its meaning concerns the relationship among men and between men and state. Quoting from **Black law dictionary,** Gildenhuys (1993: 224) defines equity as *"the spirit and habit of fairness and justice and right dealing which would regulate intercourse of men with men - the rule of doing to all others, as we desire them to do us, or as it is expressed by the Justinian, to live honestly to harm no body, to render every man his due ..."*

Mohr, Fourier and Associates (1996:445) conclude that equity is always a contentious issue. The matter is complicated further by the fact that we often do not know who actually bears the burden of taxation. Part of or the entire burden can sometimes be shifted to other participants in the economy.

3.7.2 Benefit principle

Mohr, Fourie and Associates (1996: 120) refer to the benefit principle as the factor which requires the tax burden to be apportioned to the taxpayers in accordance with the benefits each receives from government expenditure. Gildenhuys (1993) calls the benefit principle an endeavor to apply market principles in determining the price of public goods and services. But the scope for applying the benefit principle to government funding is restricted; government provides public goods and services, which characteristically are non-rival and non-excludable.

According to Nobes and James (1997/98: 78-79), the benefit approach in taxation is unlikely to be applicable, because of two reasons. First, how do you determine who benefits more from the service? For example, how can you determine who benefits more than others from defense and security. The second reason concerns redistribution; sometimes government expenditures are designed in a straightforward fashion for the redistribution of incomes. For example, in order to supplement old age pensions government raises funds through taxation; but the taxpayer does not benefit from it. The threat here is that, if the benefit principle is applied, the government will not be able to provide such services.

Aronson and Schwartz (in Gildenhuys 1993), explain that the benefit principle helps to clarify both the expenditure and tax side of government activities. The benefit principle is applicable to the allocation of quasi-collective goods and services, and the corresponding model of taxation is the 'user charge'.

3.7.3 Ability to pay principle

The ability to pay principle defines equity in the process of taxation according to the financial ability of the taxpayer. The principle insists that people should pay tax according to their ability. It has two dimensions, namely horizontal and vertical equity. Horizontal equity requires that people in the same position should be taxed equally, while vertical equity requires that people in different positions should be taxed differently. At this level of equity the rich are expected to pay more than the poor although all of them will have equal rights to the public goods.

Black et al (1999: 121-122) point out difficulties in the implementation process. The ability to pay principle requires public consensus and indicators, measures and criteria to determine paying ability. Traditionally, the measures that have been used include income tax, consumption tax, and wealth and utility taxes.

3.7.4 Types of Taxes

Tax bases that have eventually developed for the levying of different types of tax differ from one country to another. The most well known ones include income tax, sales tax or consumption tax, and wealth or property tax.

3.7.4.1 Income taxation

Income tax is based on three levels of valuation, namely personal income, cooperate income, and capital gains taxation. Income tax, like many other taxes, emerged during the mercantilist stages of state formation. It was introduced in Britain for the first time in 1779 to finance the war with Napoleon. When peace resumed the tax was abolished in 1802. The tax was reintroduced in 1842 and remained forever since (Nobes & James 1997/97: 149-150). Income tax is composed of tax on individual or company income, and some countries have a capital gains tax where the increase in the value of assets is taxed (Black et al, 1999:154).

3.7.4.1.1.Personal/individual income tax

Personal income is known as gross income, which is technically made up of receipts and accruals (e.g. wages, salaries, dividends, rents and royalties and interests). Gross income, before being taxed, has to undergo an accounting process of calculating taxable income from an individual gross income. The taxable income is arrived at after deducting all exemptions and deductions provided by the law (Black et al, 1999: 159).

Income taxation holds another version of 'tax expenditures'. These are 'expenditures' in the sense of forgone taxes, which are normally caused by the loopholes within the legislation. These include exclusions, exemptions, deductions and rebates. Exclusions are effected when some form of non-cash income such as payments in kinds are excluded from the tax base. Exemption is a type of tax expenditure that is common in administration whereby certain persons or groups of people are declared exempted from paying income tax, like soldiers, religious officials and others. It is regarded as a method of providing tax relief to the poor and aged. Deductions occur when a certain type of expenditure is excluded from tax liability as a part of personal income tax, for example, medical expenses. Tax rebates involve the subtraction of a specified amount from the tax to be paid (i.e. from taxable income).

3.7.4.1.2.Company Taxation

Individuals who pay taxes may own companies, but governments tax these companies separately from personal incomes. Certain reasons are advanced for this (Black et al, 1999:168):

- From a legal point of view companies are taxed as separate entities because the law recognizes them as a legal personalities. They function as independent institutions with their own identities.
- Companies receive benefits from the government, which include security and protection and a business environment. They utilize these services in an individual capacity. These public services are financed through taxation. So a company's income becomes liable for taxation.

- Companies are taxed separately from shareholders in order to control the possibility of tax avoidance. If companies were not taxed shareholders would decide to retain their personal incomes in the companies, thus limiting their liability to personal income taxation. Company shareholders are amongst the group of high-income earners, and taxing of companies gives effect to the principle of ability to pay.
- Company taxation is administratively simple especially in developing countries that have a limited capacity for the administration of income tax.

3.7.4.2. Property Taxation

Under personal income taxation tax is levied on an individual's income, while under property taxation tax is levied on the property owned by the individual. Technically the two differ in two respects; one is that income tax is levied on the flow of resources, while property tax is levied on a stationary resource, that is taxation of stock. Assessing the two tax bases depends on different financial reports. For wealth/property tax, the tax assessor refers to a financial statement – the balance sheet (or the statement of the financial position at one moment in time) - whereas in assessing the income tax base the assessor depends on information provided by the income statement (or statement of profit and loss for a given period of time (Sommerfeld et al 1979: 2).

Property tax is divided into two categories: personal property (furniture, motor vehicles, shares, bonds and bank deposits), and real property (land and capital invested in the improvement of land). Land means farming, residential, commercial and renting land. The capital aspect of land taxation involves farm buildings, homes and business buildings.

According to Rosen and Skinner (in Black et al, 1999:190), property tax is an unpopular type of taxation for the following reasons:

- Property taxation is a tax on unrealised capital income, which may cause solvency and liquidity problems for some taxpayers.
- The burden of the land part of a property tax is on the owner of the property at the time of taxation. Since land ownership is mostly concentrated in the hands of a few property owners and ownership is often coupled with political power, the tax is fiercely resisted.
- Land tax increases the risks of farming, which is already subject to external risks and seasonal fluctuations in income.
- Property tax requires much administrative input, for properties to be accurately identified and valued.

3.7.4.3 Indirect Taxes

Indirect taxes are type of taxes, which are imposed on commodities and are realized through market transactions. Their main characteristic is that the tax burden falls on the consumer. Originally this type of tax is collected from the salesman or a merchant, who transfers the tax burden to the consumer through price increase (Nobes & James 1997/98, Black et al, 1999, and Mhro, Fourie & Associates 1996). With income tax a taxpayer pays a tax directly based on the source of income and uses. Under commodity taxation a taxpayer pays tax through consumption. While an indirect tax is paid through commodity exchange, the direct tax is paid directly by an individual, company or a household. Indirect taxes include VAT, excise and sales duties.

3.7.4.4 Advantages of indirect taxation

Indirect taxation is based on the benefit principle. One of its advantages is that it is able to bring into tax nets those small incomes that could not be covered by the income tax system. Most small incomes operate outside of the tax net, because of being earned from informal sectors, and thus are difficult to calculate. According to Black et al (1999:96), it was only through the purchase of commodities that these sectors can be taxed.

Indirect taxation is levied on consumption, allowing the consumer to substitute a higher taxable consumption for a lower one. There is thus a chance for the consumer to make a choice. For example, if imported beer is highly taxed and thus expensive, the consumer has the chance of opting for a locally produced beer.

Consumption taxes can be used to achieve multiple objectives (Black et al, 1999: 196). It can be used to correct market failures such as externalities, by means of increasing or lowering taxes. It can also be used as deterrent and for protection measures. For example consumption tax is used for environmental protection when those commodities which have an environmental impact, are highly taxed to discourage their use. The same applies to health issues. It is common today for taxes on tobacco to be very high in many countries as a way of discouraging smoking.

Nonetheless, indirect tax is regarded as unprogressive as it contributes to reducing the work effort of a taxpayer. The assumption here is that the opportunity of purchasing luxury goods is an incentive for hard work, but because of indirect taxation the taxpayer will be opting for cheap consumption while reducing the interest to work. Additional to that, indirect tax rates may encourage smuggling.

Indirect taxation has some other recommendation as a tool used by the government to regulate trade relations. Several countries use consumption tax to protect local products against imported ones by imposing higher taxes on imported products while lessening tax on locally produced products. This helps in promoting the market for local products thus promoting local industry.

Indirect taxation is preferred by the tax authorities in developing countries because of its being relatively simple to administer compared to income tax. Indirect taxes also provide limited scope for tax evasion. Enforcement of compliance is therefore easier. However, according to Gildenhuys (1993:231-232) tax on consumption has a regressive effect, in that it hurts the poor proportionally more than the rich.

Conversely the progressivity of commodity taxation is challenged in other quarters. Black et al (1999:196) observe that the broad based taxes on goods tend to be regressive. The reason is that consumption declines when income increases. This has led to the exemption from indirect taxation or zero rating of certain basic consumer goods and services.

3.7.4.5 User Charges

Besides taxes, sources of government revenue include user charges or benefit taxes - administrative fees, borrowing and government-induced inflation. User charges are prices charged for public goods or services normally delivered by the government. User charges take the form of a market mechanism, but these charges are levied in the political market (Black et al, 1999: 113). Gildenhuys (1993: 361) defines user charges as amounts of money paid for the use of public goods containing both collective and quasi-collective services. User charges is a source of finance to the government that serves to finance the operational cost of the public services.

User charges are the result of transactions within the public sector whereby an individual is required to pay an amount of money in exchange for public goods and services delivered. This type of taxation places government in a contractual market relationship with taxpayers (Black et al, 1999: 210). The user charge is not a form of commercialization of public services, but the application of market principles in the management of public resources, where the supplied goods change from being non-rival to rival and competitive. Both government and the people will be able to make efficient decisions on consumption and supply based on the cost margin principle.

Mohr, Fourie & Associates (1996: 432) state that public goods supplied under user charges are less than public, although not totally private either; thus they have a mixed character. Rivalry for the use of public goods due to government's limited capacity for supply is limited by means of user charges. For example, public library services can elicit rivalry and competition when there is congestion at admission points and this excludes some people from the service. According to the benefit principle of taxation, user charges are usually benefit taxes that are levied where such exclusion is possible.

3.7.5 Commodity taxation in Africa

It is a given fact that African economies rely heavily on consumption taxation. Shalizi and Squire (1988:2) therefore propose that the distortion cost of these taxes should be reduced in order to strengthen their ability to generate revenue for Sub-Saharan countries. The following should be done in this regard:

- Broad-based consumption taxes such as general sales tax and Value-Added Taxes are to be used as the main mechanism to generate revenues.
- Specific taxes such as excise duties should be used to add a degree of progressivity to commodity taxes and to compensate for deductions.
- Limited import duties to provide protection are required to protect domestic producers.
- Most export taxes must be eliminated where possible (Shalizi & Squire 1988: 6).

3.8 EFFICIENT TAX SYSTEM

A tax system is evaluated for economic efficiency by referring to the degree to which the imposed tax influences the normal functioning of the economy. The response of consumers and producers, the ability to apply the resources at their disposal to meet consumption, or the ability to employ the available factors of production should not be influenced unproportionally by the tax system. Blumenthal (2000: 351) defined a good tax system as one that achieves three objectives namely simplicity, efficiency, and equity. An ideal tax system does not distort economic behavior, is borne in a fair manner by differently situated taxpayers, and is easy to understand and comply with. Failing in any of these respects may result in an incomprehensive tax system that turns out to be an additional burden to the taxpayers and their resources, thus limiting the chance for voluntary compliance.

Adam Smith in 1776 identified four elements that hamper the efficiency of taxation, namely the use of an excessive number of tax officers; inflicting penalties on the tax payers; abstracting the tax payer's industry; and finally the frequent visits to and odious examinations of tax payers. All of these account for the burden of taxation. Nobes & James (1997/97: 20-21) group these elements into three categories: the excess burden of taxation; administrative cost and compliance cost.

3.8.1 The Excess Burden

Taxation is a process of transferring the spending power from the taxpayer to the government, a process that widely impacts on the tax community. It affects the consumer and producer's choice. This occurs on two levels; first there is the change in income status of a taxpayer, and second there is the substitution effect. Taxation can reduce the income status of the taxpayer but this cannot necessarily distort the economy, but when the taxpayer decides to substitute the patterns of consumption because of the tax structure, by shifting from highly taxed commodities to lower taxed ones, or the producers decide to change the employment of factors of production in response to taxes, it distorts economic behavior and tax becomes less efficient.

For example, if a higher tax is imposed on margarine than on butter, consumers will shift to butter, while the producer will have to follow the same pattern or will be deprived of the market (Nobes & James, 1997/98: 23). The excess burden in taxation is a violation of the principle of tax neutrality. The principle of tax neutrality requires that people should not be influenced by the tax system in choosing one course of economic action rather than another solely or predominantly because of their tax position. In principle neutrality entails a neutral tax system, which is required to minimize the impact of tax rates on the economy (Gildenhuys, 1993: 223).

3.8.2 Administrative Efficiency

In an equal way administration of taxation makes for excess burden. Collecting revenue is a costly exercise that must be carried out by the government. But on the other side a taxpayer incurs costs to process tax payments, hire specialists to help complete tax returns, and communicate with tax authorities. These are called compliance costs. The administrative efficiency of any tax system entails the minimizing of the administrative cost of taxation while also minimizing the compliance cost on the side of taxpayers.

The two elements, administrative cost and compliance cost, also have a direct relationship with two other problems in tax administration: tax avoidance and tax evasion (Black et al, 1999: 143). Tax avoidance is defined as a legal manipulation by a taxpayer to avoid liability to pay tax through finding loopholes in the tax system.

Sometimes this offence is supported by poorly drafted legislation. Tax evasion is illegal and consists of an action that contravenes tax laws. The most common forms of evasion are underreporting of income and claiming more deductions than warranted. Tax evasion is quite prevalent in the informal sector. Good tax administration therefore requires that tax evasion and tax avoidance be kept at minimum level. For this purpose the golden rules in tax design are simplification of laws and procedures, and minimization of incentives for tax delinquency. Penalties for tax evasion should be high and actively enforced.

When evaluating taxes according to the criterion of administrative efficiency a number of other issues should also be considered including the level of community literacy and community tax morality. In order for taxpayers to be willing to part with their hard-earned incomes, they must be convinced of the equitable distribution of the tax burden as well as the returns expected to be accrued through public goods provision (Black et al, 1999: 144). Political will to enforce tax laws and a spirit of transparence in tax valuation and collection are elements supporting efficient tax administration.

There are seven diagnostic tests for an efficient tax system: high concentration indexes, a low erosion of the index, a low collection lag, a low specificity index, a high objectivity index, reasonable penalties and finally, low cost of collection (Tanzi 1991: 164).

Concentration index

Efficient performance of the tax system is expected to be realized from few taxes and tax rates. The concept of a concentration index refers to collecting a large share of total tax revenue from few sources. It is more transparent and easy to manage.

Dispersion index

The dispersion index means that in order for any tax system to be efficient it needs to contain the mushrooming of nuisance taxes. According to Tanzi, small and nuisance taxes obfuscate the tax system by making the analysis difficult while becoming costly for the taxpayer's compliance.

Erosion index

The erosion index of a tax system originates from either legal actions (tax holidays, exemptions, deductions and exonerations) or from illegal actions such as tax evasion and smuggling. The erosion of a tax index is a challenge to tax revenue generation to the extent that the government is thereby compelled to raise the tax rate in order to compensate the losses of eroded tax bases. Automatically this affects the concentration index while inviting more tax avoidance and evasion. Therefore a good tax system must keep the erosion index at minimum.

Collection lag index

A tax system cannot be efficient if the process of tax collection is dominated by lags in tax collection. This occurs in different tax systems either because of the tax laws that allow lags in paying tax, or because of the delinquency of the taxpayer.

Specificity index

Another test for the soundness of a tax system is the degree to which the system relies on specific taxes such as ad valorem. These types of taxes according to Tanzi (1990: 161) must be minimized in order to have an effective tax system.

Objective indexes

The efficiency of a tax system will be affected by the objectivity with which it is levied and measured.

Enforcement index

The effectiveness of a tax system is further marked by its capacity for enforced compliance. When tax compliance is not enforced, the divergence between the statutory and effective tax system may become so large that the legal tax system loses its meaning. So an effective tax system will be determined by the effective application of enforcement measures such as penalties, education and information services, monitoring of compliance and others.

Cost of collection

The cost of collecting tax should be relatively low to justify the efficiency of the system of tax collection. By and large tax collection depends on the structure of a tax system. It must also take into account other related issues. Size and geographical configuration of the country, the number of inhabitants, level of literacy in the country and the standard of accounting and bookkeeping contribute to the cost of collection.

3.8.3 Inefficient Tax Administration

It is true that several tax systems have failed to realize their objectives because of inefficiencies in tax administration. Corruption, poor record keeping, and incompetent staff, lack of equipment and unfavorable tax procedures and regulations, blurred their performances. At the end of the day, according to Tanzi (1995: 2), such tax administration reduces tax revenue, creates distortions or non-neutralities in the tax system and introduces different kinds of inequities through the tax system, for example between the honest citizen and tax evaders.

According to Tanzi (1995) there are five causes of inefficient tax administration: tax laws themselves which appear to be complex and opaque demanding difficult information from the tax payer; inefficiency originating from the political system, whereby the policy makers legislate and make decisions on a tax system in a biased manner; lack of the necessary degree of professionalism; and lack of a clear strategy for improving efficiency.

There are different things that contribute to lack of professionalism: lack of a proper rewarding system; approaching administration as routine work in performing tasks in hand; where salaries are low and do not differentiate between bad and good workers; where tax inspectors are not above accepting bribes for preferential treatment; and political interference in tax administration (Tanzi 1995: 3); lack of a clear strategy for reforming tax administration; and the economic system.

3.9 EFFECTIVE TAX SYSTEM

A tax system is the set of institutions and policies that determine the process of taxation in the country. In economic terms a good tax system characteristically needs to be fair to the taxpayers and to the government, and is required to be consistent with macroeconomic policies (Nobes & James 1997/98: 132). A tax system is also referred to as the interrelationship between structures and tax administration (Gillis 1989:8). All in all there are different attributes of a tax system that cause the unraveling of efficiency and effectiveness of taxation both in public economics and public finance. Ariyo (1997:8) has commented that in both developing and developed countries the tax structure has a direct relationship with economic growth and development. And for that matter the tax system is a major determinant of other macroeconomic indexes.

Tanzi (1991:158) has outlined what he calls the characteristics of an effective tax system. In his analysis he points out that a tax system is divided into two lines of analysis, one is statutory and another is effective tax. The statutory tax system is provided by the law, but is not regarded as an effective system until the administrative inputs are made to implement the system. Therefore an effective tax system is an evaluating factor for the implementation of tax laws and policies.

A tax system is further threefold in character. Tanzi (1995:1) describes a country's tax system as something that can be analyzed in terms of statistical, statutory, and effective ways. The statistical description allocates actual tax revenue and provides an impression of the revenue importance of various tax bases and tax rates; the statutory description is one found in the codes, tax laws and tax regulations; the effective descriptions is based on economic reality taking into account all the distortions caused by tax evasion, tax avoidance, misapplication of laws, abuses on the part of tax officials and so forth.

In the next section we see how an efficient and effective tax system is translated into effective and efficient tax compliance.

3.10 TAX ADMINISTRATION AND COMPLIANCE

Usually the term tax compliance is used in terms of the degree to which a taxpayer complies with a tax law (Nobes & James 1997/98: 137). No tax system can function effectively without the cooperation of the majority of taxpayers. Compliance therefore means the cooperation of a taxpayer in the taxation process. The broader definition of tax compliance would be the degree to which a taxpayer complies with tax law, and administration without the need of enforcement activity (Nobes & James 1997/98:138).

The US Internal Revenue Service defined tax compliance in a framework consisting of reporting and that a compliant tax payer files all required taxes at the proper time, that the returns accurately report tax liability, and that it is in accordance with internal revenue codes and other regulations and court decision as applicable at the time and are adhered to (Hasseldine 2000:299). Kinsey in Hasseldine (2000) defines non-compliance with tax laws as the intentional or unintentional failure of taxpayers to meet their tax obligation. In any case, compliance and non-compliance are the result of behavioral patterns of taxpayers in the process of taxation. There are certain patterns of non-compliance such as:

- Non-compliance is wide spread.
- Non-compliance includes unreported income, overstated subtractions, not filling in tax returns and calculation errors.

- Not all instances of non- compliance are in the taxpayer's favor. There are sometimes an over reporting of income and sometimes a taxpayer does not claim the deductions which she or he is entitled to.
- Most instances of non-compliance involve small amounts (Hasseldine 2000: 301).

In the process of insuring compliance, tax administration is required to provide a service to the taxpayer to meet his/her compliance objectively, improving tax payers' confidence, easing the burden of compliance, and dealing with tax law complexity (Le Baube & Vehorn 1992: 310).

The argument of assisting taxpayers is regarded as a function of government in the process of taxation. Adam Smith in early days referred to this as an important area of government objectives in taxation:

- To support those citizens who wish to comply with tax laws by making compliance as easy as possible.
- To minimize the amount of public and private resources diverted to other uses in order to ensure that taxes are well collected.
- To strive through education to increase the number of willing compliers (Le Baube & Vehorn 1992:310).

In this regard tax administration has three responsibilities (Silvan, 1992 in Bird & De Juntscher, 1992: 8). The first is to facilitate tax compliance by providing a service to the taxpayers, by providing them with clear instructions, clear forms, and clear information. Second is the monitoring of compliance, by establishing and maintaining the current account of taxpayers and management of information systems covering both ultimate taxpayers and third party agents such as banks by maintaining appropriate and prompt procedures in detecting non-filers. Thirdly, tax administration must deal with non-compliance.

Silvan (1992) further emphasizes that the main goal of tax administration is to foster voluntary tax compliance. Penalizing tax evaders or going after delinquents are not in themselves objectives of tax administration, voluntary compliance must be encouraged irrespective of the good performance of the administration. The two levels of differentiation, enforced and voluntary compliance, are the test of functionability of tax administration in utilization of the enforcement resources. Voluntary compliance is similar to self-enforced compliance, which mostly is achieved through civic education measures and building of trust between taxpayers and the tax authority. Radian and Sharkansy (1990: 106) regard voluntary compliance as central to tax policy, at the same time being an instrument of the tax administration to collect taxes from large masses of taxpayers. These two tax analysts state that without voluntary compliance the process of eliciting taxes from large masses would overwhelm tax agencies.

According to Silvan, voluntary compliance does not deprecate the use of penalties in tax administration. He emphasizes that taxpayers will comply effectively if they believe that not doing so will mean that they can await the substantial risk of being penalized in a relatively severe fashion. Of course, administratively there are also other factors expected to be in operation for the tax administration to sustain voluntary compliance that has a low cost for the taxpayer to comply and for the government to enforce. These factors would include fairness, simplicity of laws and procedures. These and others are provided by effective tax administration.

3.10.1 Effective & Efficient Compliance

Silvan in Bird & De Junstscher (1992: 275), when distinguishing between effective and efficient tax administration, maintains that the maximum level of voluntary compliance is the reflection of the effectiveness of tax administration. By the same token, the level of enforcing compliance at the minimum rate will determine the efficiency of tax administration.

In countries characterized by non- compliance, the ability of tax administration to impose effective penalties is a key to shaping the behavior of taxpayers. Silvan (1992) identifies some common shortcomings found in non-compliance areas:

- Unregistered taxpayers: This originates from the gap between registered taxpayers and potential taxpayers.
- Taxpayers who do not fill in tax returns: This is reflected in the difference between registered taxpayers and potential tax according to the law.
- Tax evaders: This is the difference between the tax reported by the taxpayers and the potential tax according to the law.
- Delinquent taxpayers: This is the gap between the amount of taxes taxpayers are reported as owing and that which the tax administration may eventually assess.

The above four reasons for shortfalls in tax revenue provide indicators to evaluate the effectives of tax administration for compliance. The objective data must be looked at to estimate the degree of effectiveness displayed by the administration dealing with each gap. In any case the issue here is not only to ensure that the shortfalls have been prevented but how administrations are effective in dealing with it (Silvan in Bird & De Juntscher, 1992: 275).

Etcheberry in Bird & De Juntscher (1992) when commenting on Silvan's shortfalls adds another level of classifying non-compliance by classifying taxpayers according to geographical areas, the economic activity they perform, and the size or legal status of their business.

Among the tools mentioned by Silvan to deal with the above shortfalls are the monitoring of the four situations in order to be able to identify where the gaps are, tax auditing and an effective information system.

3.10.2 Information System

Controlling the above examples of non-compliance entails introducing computer equipment to improve the performance of tax administration. Yet according to Silvan, computer technology has been in use in tax administration for a long time but has failed to help realize the intended objectives because of unreliability. Many developing countries have been spending millions on buying computer equipment without being able to improve the effectiveness of their tax administration (Silvan in Bird & De Juntscher, 1992: 300). The generic problems identified with the failure of information systems in the developing countries include:

- The systems are not reliable; they produce a number of considerable errors.
- Control is often done manually.
- There is no adequate follow-up for collecting delinquents' taxes.
- The use of TIN (tax identification number) is not reliable enough.
- An independent manual system is used to keep record of payment.
- Processes are duplicated because the same bits of information are transcribed over and over again for different purposes.
- The systems are too rigid and incapable of swiftly adjusting to changes in tax legislation.
- There are duplicates of files for documents.
- Statistics are not available timeously.
- There are no systems to support enforcement activities.

The above realities highlight the fact that tax administration does not function only to collect revenue but also to provide the means how the revenue can be collected.

Birds and De Juntscher's argue that the best tax administration is not simply one that collects most revenue, more important is how that revenue is raised – taking into account the effect of the revenue generation effort on equity, on the political fortunes of the government and on the level of economic welfare.

A poor quality tax administration may collect large amounts from easy to tax sectors, such as wage earners, while it is unable to enforce taxes on business enterprises and professionals. The level of collection is therefore a somewhat unsophisticated measure of the effectiveness of tax administration. A more accurate measure in tax administration is the size of the 'compliance gap' - that is, the gap between actual and potential tax revenue - and how that gap varies among the different sectors of the tax-paying population.

As we have seen from the above in chapters 1 and 3, tax administration is the mainstream of a tax system. Birds and De Junstcher, referred to in chapters 1 and 3, indicate that tax administration means the tax policy, so the tax system entails the administrative behaviour of a tax system. The next section in detail therefore examines what the reform of a tax administration entails.

3.11 REFORMING TAX ADMINISTRATION

A country's tax administration represents an institutional arrangement through which citizens fulfill their obligation to the government. A tax administration should strive to be both effective and efficient. A tax administration is effective when all citizens attain a high level of compliance. Efficiency, as we saw above, is achieved when the administrative cost of tax revenue is minimal. The government is however frequently warned not to pursue efficiency at the expense of effectiveness. Achieving a balance between efficiency and effectiveness or at least moving towards it, must be the goal of tax administration reform (Tanzi 1995: 10-11).

Tax administration covers a wide area and its impact is widely felt in a country. It involves different aspects of government management, and economic and social change. Reforming tax administration therefore requires careful analysis. Tanzi (1995: 5) identifies the basic elements for tax administration reforms as follows: an explicit and sustained political commitment; a team of capable, hard-working officials dedicated full time to tax administration reform; a well-defined and an appropriate strategy; relevant training; additional resources or reallocation of existing resources; and changes in incentives for both taxpayers and tax administrators.

In the same vein, tax analysts Bird and De Juntscher (1992: 3-4) have identified the pre-conditions for the reform of a system of tax administration as: Simplification of the tax system insuring that it can be applied effectively; a strategy and comprehensive plan that assigns clear priorities to the task that must be performed, tailored to the available resources; and commitment; commitment from policy makers as well as managerial and technical support.

The above two versions of requirements for tax administration reforms have two things in common, the internal dictates within the system of tax administration and the influences emanating from the relationship between tax administration and political structures in the country. Neither of the two can be addressed without another (refer to topic of taxation and quality of public sector above).

Political commitment provides fertile ground for reforming tax administration through the enactment of laws and adoption of reform policies. Political commitment in this case means that the will and knowledge of policy makers are profound for reforming tax administration. Likewise internal managerial capacity that entails proper sets of plans and strategies for reforming the system of tax administration, professional, well-motivated and trained technical and managerial staff, capable of charting out the course of reforms, are indispensable elements.

Reforming tax administration is a process that aims at achieving efficiency and effectiveness in a tax administration. Tanzi describes how tax administration reform has, by means of an intervention to improve effectiveness, measures to improve efficiency of tax administration (Tanzi 1995: 11-20).

3.11.1 Measures To Improve Effectiveness

For tax administration to be made effective Tanzi recommends five tools which can be used by a tax authority: intervention to improve voluntary compliance; adoption of the principle of self-assessment; taxpayers education; prompt detection of tax filling and paying; and improvement of audit coverage.

Voluntary compliance - the primary goal of tax administration should be the highest possible voluntary tax compliance. This is determined by how the administration has employed scarce resources to identify instances of non-compliance, and taking appropriate action.

Adoption of principle of self-assessment - this step entails empowering the taxpayers to assess and pay tax liabilities according to prescribed procedures. Clear instructions, procedures and sufficient encouragement are needed in order to attain this objective, thus reform in tax administration must effectively address the institutionalization of this ingredient.

Taxpayer education – taxpayers must be equipped with basic knowledge of who is to be taxed, what she or he is to be taxed, how to pay taxes and how to calculate his/her tax liabilities in order to carry out his/ her own tax self-assessment. This can only be achieved through taxpayer education.

Prompt detection of tax filling and paying - a critical step in tax administration is the prompt detection of taxpayers who fail to submit tax returns (stopfilers) and taxpayers who fail to calculate correctly their tax liability on their tax return or make timely payment (delinquent taxpayers). A key function in tax administration is to ensure that if taxpayers fail to comply, this is followed up by means of notifying them, significant penalties, and other remedial actions. It is important to convey the impression that, in this area, "big brother is watching".

Given the need for an accurate up-to-date register in order to detect stopfilers and delinquent taxpayers, tax administration reform should establish whether there is a problem with non-registration. This must include ensuring that all the businesses are properly registered. Records of registered taxpayers must be examined in order to detect suppliers or customers who are not registered taxpayers.

Tax administration reform should be guided by the need for adequate resources to detect stopfilers and delinquent taxpayers. This encompasses the development and implementation of a system for tax return processing and accounting that quickly and accurately records taxpayers' transactions with the tax administration and speedily identifies stopfilers and delinquent taxpayers (Tanzi 1995: 12).

Improvement of audit coverage – Non-compliance extends beyond stopfiling and delinquency to encompass fraudulent actions by taxpayers to understate their tax liability in ways that cannot be detected in the collection process. In a modern tax system it is critical for taxpayers to believe that if they engage in such fraudulent actions, they will be caught and appropriately penalized. Also, it is important that taxpayers be confident that their competitors are paying the same taxes so they may compete fairly. This requires that an effective audit program be carried out by the tax administration.

Taxpayer compliance depends to a significant degree on their belief in the effectiveness of the audit program. Further, the chance of being audited will appear greater, and compliance will be higher, if the actual details of the audit program are not known. It is important that taxpayers believe that a larger percentage of taxpayers are audited than is actually the case. This suggests a rationale for the tax administration not to disclose the information regarding its audit selection strategy and the number of taxpayers to be audited in a given period of time. Instead, the tax administration should promote the view that a variety of factors may lead to an audit. Towards the end, the tax administration should show taxpayers that it has both the information and the capacity to detect violations.

An audit plan represents a strategy to detect violations as efficiently as possible using the different types of audit with the resources available to the tax administration. The plan should specify how many of the different types of audit should be conducted each year in each local tax office, with the proportions varying based on the registration of new taxpayers, business developments, and the results of previous audits. The plan should reflect an analytical approach to increasing the probability of detection. Specific strategies would likely vary from year to year. For example, one year it may be decided to conduct a wide audit of taxpayers in the same or similar business, say restaurants. In another year, more audits might be conducted than usual on wholesalers..

Application of adequate penalties – The tax system can be expected to function smoothly and yield anticipated revenues only if adequate penalties are imposed for violations that strike at the heart of the tax system, such as failure to file returns and to pay tax on time. It is important that interest provisions for late tax payment compensate the government for the time that the taxpayer had the use of the government's revenue. The total interest cost of late tax payment should exceed the interest rate for borrowing money – it should be less costly for the taxpayer to borrow than to pay taxes, delaying tax payments, as a way to obtain cheap financing from the government must be prevented. In addition, it must be accepted that if registration and other requirements critical for a smooth functioning tax system are adopted, adequate penalties should be applied for violations of these requirements as well.

The theoretical literature on tax evasion has often concluded that if penalties are high enough, audit coverage can be limited. In a way, the literature has suggested that there is a trade-off between administrative expenditure and size of penalties. However, when the penalties are very high and audits are rare, the penalties are unlikely to be fully enforced by the magistrates. Furthermore, the taxpayers can appeal these sentences and delay for years the application of the penalties. Thus, the penalties lose their deterrent value. Highly visible penalties such as the closing of shops for a few days of a few weeks by government as was done effectively in Argentina, Chile and Peru may bring better results.

3.11.2 Measures to Improve Efficiency of Tax Administration

Along with an overall strategy outlined above for enhancing effectiveness, tax administrations can adopt a number of measures to focus their scarce resources in the most efficient manner for revenue collection and enforcement. Tanzi (1995: 14-20) presents the following measures as fundamental in order to attain the efficiency in tax administration: Establishment of a Large Taxpayers Unit; adoption of a threshold for tax registration; imposition of some form of alternative tax; use of final withholding; use of banks; and organizational considerations.

3.11.2.1 Establishment of a Large Taxpayers Unit

The establishment of a Large Taxpayers Unit can be an effective initial step towards an efficient tax administration. This special unit, possibly made up of an elite group of better trained and less corruptible officials, monitors collection of taxes from taxpayers who, although not large in number, account for the major part, sometimes as high as 90 percent, of tax revenue from consumer taxes and corporate income taxes. Such a unit can virtually guarantee the timely collection of most tax revenue and the prompt identification of stopfilers and delinquent taxpayers so that appropriate action, including the imposition of penalties, can be taken. A Large Taxpayers Unit can significantly reduce errors in tax declarations and minimize delays in the collection of substantial amounts of revenue due to errors, late filing and other violations. Such a unit properly focuses in initial efforts in tax administration reform on the adoption of more efficient procedures for the more important taxpayers, rather than on small taxpayers whose revenue generation is not substantial.

A Large Taxpayers Unit serves as a model for the adoption and expansion of modern tax administration practices for other taxpayers. In many countries, Large Taxpayers Units were introduced as pilot projects, thus allowing the tax administration to try out new methods and technologies. The successful implementation of such pilots demonstrates to the tax administration, which as a bureaucracy tends to be resistant to change, that it is possible and advantageous to modify procedures and systems. In many countries the Large Taxpayers Unit was applied to progressively larger groups once these modern practices were tested. For example, Argentina initially developed these new practices for a group of less than 1 000, but has since expanded the group to more than 200 000.

Large Taxpayers Unit may include executing not just the collection, but also the audit function, for several reasons. The detection of evasion is important for the same reasons as the monitoring of compliance with filing and paying requirements for large taxpayers. In addition, large taxpayers usually carry out a high volume of transactions and have complex operations. They frequently have several branches of operations and sometimes branches outside the country. They have skilled accountants and lawyers, and may use forms of evasion that are difficult to detect, such as transfer pricing. These characteristics of large taxpayers often make it necessary to establish special monitoring units with highly specialized staff.

3.11.2.2 Adoption of a threshold for tax registration

In a modern economy, it is not feasible to collect all major taxes from every economic enterprise. The accurate computation of tax liability by a taxpayer, and its control by the tax administration, requires that the taxpayer be able to maintain books and records of a certain minimum standard. Furthermore, for the system as a whole to operate reasonably and effectively it is not necessary that every enterprise should be liable to pay all taxes that apply to enterprises. For example, the objective of the VAT is to impose a tax on the value of goods and services consumed by individuals. This tax is collected from enterprises on the basis of their value added (and also on imports), as a matter of convenience. In effect, although such enterprises are specified as taxpayers in the VAT law, they are acting as "tax collectors". The operation of such a system is not undermined significantly if small-scale enterprises, which, even though their numbers may be very large, account for small proportions to the value of goods supplied to final consumers, are exempted from liability to pay the tax.

In most cases, in all VAT systems, small-scale enterprises are exempted from liability to pay the tax. For this purpose, the most satisfactory measure of the size of the enterprise is its annual turnover; those enterprises with turnover below a certain threshold are not required to register as VAT taxpayers (though they may be liable to pay other taxes, such as corporate income tax). This provision is necessary to allow the tax administration to concentrate its limited resources for controlling and monitoring the VAT on those taxpayers that account for the major part of value added. The appropriate level for this threshold should be calculated in such a way that potential VAT revenues are reduced by only a small percentage.

3.11.2.3 Imposition of some form of alternative tax on small taxpayers

With the threshold proposed above, most small enterprises engaging in cash transactions would not be liable, in principle, to pay VAT on their sales, and would not receive any credit for VAT already paid on their purchases. Every country finds it difficult to tax income (or value added) of small traders in an appropriate manner. To assess the true level of income reasonably accurately when most transactions are not recorded, can absorb considerable resources and the revenues generated by this use of the tax administration's limited resources are likely to be small.

Three main alternative solutions to this dilemma have been adopted in different countries. The first is to levy an annual license fee on small traders, as a rough substitute for liability to VAT, income tax, or both. Different license fees are often set for different types of businesses. Such fees need to be set at a level high enough to act as a reasonably fair substitute for income tax or VAT, but not so high as to discourage enterprise.

The second approach is a "presumptive tax," under which the taxable income of the small business is computed indirectly on the basis of certain objective indicators, such as the value of goods for sale, the number of employees, total wages paid, and the amount and type of physical assets. Estimating taxable income on a presumptive basis can, however, require considerable effort on the part of the tax administration.

The third general approach to taxing the incomes of small traders engaged primarily in cash transactions relies on the withholding of tax on their purchases. In many countries, imports by traders who are not registered for VAT, and sales of goods to such traders by registered enterprises, are subject to a special withholding tax, which is typically around two percent of the value of the purchase. Traders who believe that the amount withheld by their suppliers exceed the liability on their value added have the option of registering for VAT and submitting returns showing their actual VAT liability.

3.11.2.4 Use of final withholding

Withholding taxes on income when it is earned is a mechanism widely used in developed and developing countries for collecting revenue with minimal use of administration resources. Tax withholding is a very important mechanism given the large volume of revenue collected through withholding in many countries. A popular mechanism is wage withholding; commonly know as pay-as-you-earn (PAYE), in which employers are withholding agents for personal income tax on the earning of their employees. This shifts the tax administration's monitoring responsibilities from a large number of individual taxpayers to a much smaller number of employers, thus achieving a more efficient focusing of administrative resources.

Taxes can be withheld on sources of income rather than wages by collecting from the payer rather than the payee with the same efficiency gains. This includes payments of interest by banks, dividend payments by companies to stockholders, interest and dividend payments by mutual funds, and other like payments.

3.11.2.5 Use of banks

Banks have a natural role in the administration of taxes, as they constitute institutions well suited for receiving tax payments. Banks are accustomed to receiving payments and handling money, and are well equipped for this task. The main tax administration services provided by banks entail the receipt of payment forms, the receipts of money from taxpayers, the deposit of these monies into the proper tax accounts, and the banks are also responsible for processing tax returns combined with payment forms: this system has substantially improved the efficiency of payment. The responsibility for maintaining an accurate record of taxpayers' transactions and enforcing the collection of taxes remains, however, with the tax administration.

3.11.2.6 Organizational considerations

The measures discussed above for improving the effectiveness and efficiency of tax administration strongly influence the organization of the tax administration. Once the tax administration determines its key functions, an organizational structure should be adopted to support these functions. The discussion in the previous two sections suggests the following five principal functions:

- Taxpayer education: staffs in this function are responsible for educating and assisting taxpayers in tax matters. They distribute printed material that explains tax regulations. They respond to inquiries from taxpayers. This is a very important function that in the past often did not receive the attention that it deserves. Countries such as Canada, New Zealand, and Trinidad and Tobago provide good examples of successful taxpayer education.
- Registration, accounting and returns processing. Staffs in this function are responsible for data entry and the processing of declarations and payments processing. For instance, if a taxpayer uses the wrong tax rate, a computer can detect the error and automatically send a letter asking for payment at the correct rate. After the data have been verified, they are stored in a master file, which is a central record of all taxpayer transactions with the tax administration.
- Collections enforcement. The emphasis of this function is on collection of taxes from stopfilers and delinquent taxpayers. Basically, all compliance
- control except inspection is centralized in this function. The accounting and processing department provides much of the information that is needed.

- Audit. The audit function is devoted to the detection of underreported taxes. Staffs in this function usually perform audits of taxpayers' files and record the tax administration office or audits of business activities and records at the taxpayers' premises. It is important to note that the accounting and processing department will already have performed routine checks.
- Legal services and appeals. The staffs in this function take cases to court, defend tax authorities against legal appeals, and provide advices as to which actions are legal and which are not.

Within a functional organization, the workflow within the tax administration is more specialized in order to best support a self-assessment system. The main objective is to identify the exceptions, that is, in the instances of noncompliance. The major part of the staff concentrates on the exceptions, as well as on audit to check compliance. Such an organization entails a strategic element of self-checking among staff whereby the work in one function serves as a control on another. In other words, the organizational structure itself becomes a self-enforcing measure.

3.12 PRIVATIZATION OF TAX ADMINISTRATION

Putting the private sector in control of the tax function has been an endless point of debate in the area of public-private partnerships. Traditionally taxation is known as a classical function of the state, but there are suggestions that some parts of tax administration can be run by the private sector without government losing control. Above all, the privatization of some functions of a tax system continues to get precedence through the new paradigm of public-private partnership (Acuna 1992: 377).

However, privatization of tax collection is not new to the history of tax administration. It existed in Europe as 'tax farming' before the emergence of the modern public administrative structures in the 17th and 18th centuries (Bird 1989: 322). According to Bird, privatization of tax collection is still possible in modern times without applying the tax-farming system that was so unpopular during its age. The present practices of privatizing some important functions of customs in Indonesia and Jamaica is an indication of that possibility.

The growing practice of paying private collectors for tax collection is a form of private sector involvement in tax administration without impairing the control of the government. In Senegal tax inspectors are rewarded in accordance with the amount of additional tax and fines they collect. In fact, tax commissions and privatization of tax collection imply the use of third parties in tax collection. Withholding wages by employers or withholdings of banks on profit tax are methods of utilizing third parties in tax collection.

3.13 TAX SYSTEMS IN DEVELOPING COUNTRIES

Patterns of tax paying in developing countries differ from one country to another. In most cases, however, they share basic historical and economic factors. The common characteristic of tax structures in developing countries is that personal taxes are hard to collect because of predominantly agricultural economies where people are widely dispersed. Generally speaking it is a diminishing tax base. As a result the personal tax base is limited to only public employees and employees of big firms and particular multinational companies (World Bank 1991: 16).

Additional to that, because of administrative flaws, tax structures in developing countries rely much on taxes on goods and services, especially trade taxes.

Income tax is however regarded as an important tax system in a modern economy as it permits moderate progression in the distribution of the tax burden (Musgrave 1987: 251) although its percentage contribution is low against total revenue in developing countries. There are two schools of thought on this. One relates to the level of development, including income per capita of the people, and the second is the administrative capacity of the tax system (Newberry & Stern 1987, Tanzi, 1987 & 2001, Goode 1962, and Musgrave 1987).

According to Goode (1962) the large agricultural sector, poor accounting systems, low level of literacy and the fact that most economic activity takes place in small establishments, cause the effective income taxation to be low. Musgrave (1987: 250) is opposed to the idea of income tax, because developing countries are in need of capital formation and saving, so preference should go to consumption tax instead of depending on income tax, which draws from individual and company's savings. But consumption in developing countries is so low that it cannot cause a surplus to be transferred to the budget. Musgrave therefore argues that although consumption is low for the large part of the population in developing countries, due to the common phenomenon of unequal income distribution among the poor communities, there will be a limited scale of luxury consumption that provides a base for taxation (Newbery & Stern 1987: 250).

The poor performance of income taxation is attributed to the combination of two factors, namely economic development as measured by per capita income, which affects the contribution of income tax in developing countries, and the highest level of avoidance, and exemptions, which are common in tax administration in developing countries (Tanzi, in Newbery & Stern, 1987:245). Because of limited administrative capacity many of the tax systems in developing countries depend on indirect taxation, which includes sales taxes, and foreign trade.

The fundamental challenge of many tax reforms has been the issue of administrative capacity of tax systems. Tax administration as was defined in

Chapter 1 is referred to as the "real policy of taxation". It deals with the legal and procedural framework of the tax system - tax assessment, collection, auditing, sanctions, appeals and record keeping as well as tax information management. Tax administration represents the qualitative aspect of a tax system and must be properly organized, well equipped, especially with information technology and staffed with well-trained, motivated and innovative staff.

Different tax analysts on tax reform in developing countries have been converging on a common line that the strengthening of tax administration is as critical as the success of tax reforms. In other words tax reforms need strong tax administration to be successful (World Bank 1991: 51). Bird and Oldman (1990:450) have observed that tax administration is central and peripheral to tax reform in developing countries. The problems of tax administration in developing countries, according to these two analysts, include poor training, low status, poor salaries and poor equipment. In order to reform tax administration, therefore, it is necessary to review the organizational and procedural aspects, while insuring that laws are properly drafted and codified; that the administration is properly organized, well staffed, and trained, that taxpayers are located, placed on the tax roll and that their returns are adequately examined and audited; that relevant information obtained from other government departments elsewhere is utilized; that controversies between taxpayers and administration are adequately resolved.

Tax administration starts with the enactment of laws, the identification of taxpayers, the assessment of tax; the control and verification of assessment; tax litigation; and finally the collection of taxes. These are categorically the instruments of tax compliance. Therefore tax administration reform should be aimed at improving the compliance of taxpayers, the efficiency with which taxes are assessed, and collected.

Tax administration is a formidable challenge to developing countries, where large numbers of taxpayers are technically operating outside the tax net. Workers in these countries are typically employed in agriculture or in small enterprises. As they are seldom paid in regular, fixed wages, their earnings fluctuate and many are paid in cash off the book. The income tax base is therefore hard to calculate. Nor do these workers typically spend their earnings in large stores that keep accurate records of sales and inventories. As a result modern means of raising revenue, such as income tax, and consumer taxes, play a diminished role in these economies and the possibility that such a government will achieve a high level of growth is virtually nought (Tanzi & Zee 2001).

Tanzi & Zee (2001) underlines the factors that threaten the creation of efficient tax administration in developing countries. Among these are a lack of well-educated and trained staff, poor payment of tax officials, lack of capacity to computerize the tax operations (or even to provide efficient telephone and mail services) and limited ability of taxpayers to keep accounts. As a result, governments often take the path of least resistance, developing tax systems that allow them to exploit whatever options are available, rather than establishing a rational, modern, and efficient tax system.

This situation has been affecting the efficiency of the systems in these countries in terms of tax equity and tax neutrality. The tax burden is being carried by the few whose earnings can be recorded, while other economic operators have been shifting to informal economic undertakings, hiding from taxation and thus affecting neutrality as well as encouraging tax evasion and avoidance.

The current trend in developing countries to integrate into the world economy calls for new sophisticated tax policies in order to remain competitive in the global economy. The changes in the international trade influenced by economic liberalization, compel the developing countries to shift their reliance on foreign taxes to domestic taxes. This reality further calls for the strengthening of tax administration.

3.14 CONCLUSION

The chapter explored the theoretical foundations of tax and tax administration. Apart from theoretical definitions and applications of the four maxims of taxation, the chapter observed in depth the essence of taxation and its role in relationships between government and the citizen. Taxation and legitimation of political systems, taxation and public goods and service philosophy, taxpayer's participation and the quality of public institutions and their effect on taxation were topics that drew attention to the position of tax in government's functions of distributing the resources and stabilization of the economy.

The chapter also concentrated on the conventional theories of tax and tax systems. In this discussion topics of the types of taxes were reviewed, factors contributing to an efficient and effective tax system, tax administration and compliance, how to undertake tax administration reforms, and measures for effective and efficient tax administration were outlined.

The chapter also reviewed how the private sector can be involved in tax administration, which traditionally has been recognized as the sole responsibility of the government and its institutions. References and current experiences have shown that a modern tax system has room for accommodating the new paradigm of public–private partnerships. Finally tax administration and tax structure in developing countries were explored. In the next chapter tax system reform in Rwanda and its shortcomings in relation to normative requirements as observed in chapter 3 will be explored.

CHAPTER 4: ANALYSIS OF TAX SYSTEM REFORM IN RWANDA

4.1 INTRODUCTION

The purpose of this chapter is to provide an analysis of the implementation dynamics of tax system reform in Rwanda. Chapter 1 has set a conceptual foundation for the research problem, hypothesis formulation, and research methodology and techniques. Chapter 2 analysed and evaluated the background situations that preceded and eventually affected the policy decisions on and in implementation of tax system reform programme in Rwanda, while Chapter 3 contained a closer scrutiny of existing literature to establish the normative requirements of a tax system.

In this chapter, therefore, the main issue is the operationalisation of the tax system reform programme. The researcher analyses and evaluates how the reform process is impacting on tax structure and tax administration, how the institutional and structural issues are dealt with and how the reform is realising the normative requirements for a tax system. All of this will be examined through the following related issues:

- The trend of tax system reform in Rwanda, including reform phases.
- Reforming of tax structure, with reference to the **income tax reforms; corporate tax; establishment of large enterprises; presumptive taxation**; and **control of exemptions**
- **Consumption tax reforms** with reference to the tariffs reduction policy; introduction of VAT.
- **Tax administration reforms,** including legal and procedural simplification with reference to tax flaws in customs, improving tax collection and accelerating auditing of enterprises.
- **Institutional reforms,** reference to the Rwandan Revenue Authority, its structure and functions.

4.2 THE TREND OF TAX REFORMS IN RWANDA

The process of reforming the tax system in Rwanda can be categorized into two successive phases, 1995-97 and 1997-99. In practice the reforms have been a continuous process from 1995 to the present. But in order to create a barometer for this study it is possible to divide the process into two major phases. Tax reforms in Rwanda have been adopted and implemented within the macro economic reform frameworks, so the analytical framework for tax reform in Rwanda should be conceived within the macro-economic reform programmes that have been in place since 1995.

The first phase of tax reform (1995-97) was conceived within the three-year national Economic Recovery Program, which was the first macro-economic policy reforms adopted by the new government after the 1994 genocide and war. The second phase, 1997–1999, which was essentially a continuation of the first, was implemented within the broader program of macro economic reforms known as **Economic Structural Adjustment Facility** (ESAF) sponsored by the IMF and the World Bank from 1997 –1999/2000.

4.2.1 Phases

In launching the first phase of tax reforms, 1995 –1997, the government described the aim of reform as the rapid restoration of the revenue base, through a number of temporary and structural measures, including the rebuilding and strengthening of the capacity of revenue administration and implementing a range of discretionary measures to increase tax revenue contribution (IMF No 4/2000).

The first measure to be declared by the government included the establishment of a Large Enterprises Unit that later became responsible for assessing and collecting taxes from the 150 largest taxpayers, accounting for 80% of total tax revenue in the country. Additional to that the government declared new measures to restore and improve the capacity of the customs authority, including the provision of basic equipment and reinforcements for mobile surveillance and anti smuggling operations (IMF No 4/2000).

The second phase was embedded in an economic structural adjustment program, which introduced different reform measures including:

- The establishment of the Rwanda Revenue Authority (RRA), with the aim of strengthening tax administration;
- The strengthening of the Large Enterprises Unit;
- The gradual inclusion of small enterprises into the tax net by offering to self-employed persons or small enterprises (with an annual turnover of 60 million RWF or less) the choice of paying either presumptive income tax of 4% of annual turnover or the regular income tax;
- The curtailment of exemptions; and
- The conversion of coffee tax into an *ad valorem* tax at the rate of 16% (IMF No 4/2000).

In 1999, the government intensified the reform process by introducing different administrative and structural issues, including the withholding of income tax from its suppliers, and revising the system of penalties for late payment. These measures were accompanied by a number of customs administrative reforms, which involved the reshipment inspection of all petroleum products and tightening the control on transit goods, and the introduction of a taxpayer identification number (TIN) used for both inland revenue collection and at the customs. By 1999, all large enterprises and half of the smaller enterprises had been assigned tax identification numbers.

4.3 TAX STRUCTURE REFORM

Tax structure, as we saw in the theoretical framework of tax reform in Chapters 1 and 3, is part of a tax system and is composed of the tax base and structure rating. The tax base includes a valuated tax object for taxation. If income is an object of taxation, for example, the tax base will be income related, hence personal income tax, corporate tax and profit tax. If the object of valuation is a commodity, then the tax base will be commodity related, hence sales tax, export tax, and import tax.

4.3.1 Income Tax Reforms

As has been mentioned in Chapter 2 and Chapter 3, the performance of income tax in Rwanda, as in many of the developing countries, has been hampered by an economic structure dominated by subsistence agriculture and an informal production sector. Table 2 in Chapter 2 shows that 94% of the Rwandan population is employed in the rural sector, mostly in subsistence agriculture, and that 50% of the secondary economy is taken up by informal business activities where incomes are not accessible for income taxation. The modern industrial sector contributes only 6% of the national GDP, while the service sector contributes only 30% and agriculture 40.95%.

However, the two-phase tax system reform program in Rwanda focused on different measures for the revitalization of income tax regimes. The process started with parliament enacting the Code for Direct Taxation in 1997, to amend the income tax law of 1964. The code articulated new measures for income tax administration in the country, including a reduction in company and maximum personal income taxes from 50% to 40%, the imposition of income tax on public enterprises and on military personnel, the introduction of a Large Enterprises Unit and the imposition of presumptive taxes on small enterprises, and a curtailment of a series of tax exemptions.

4.3.1.1 Corporate Tax Reform

Reforming the corporate tax base went hand and hand with the establishment of a unit focusing on large taxpayers, in 1995. This strengthened the country's capacity to administer company tax. The unit became responsible for assessing and collecting taxes from the 150 largest taxpayers in the country, accounting for 80% of total tax revenue. The Large Enterprises Unit became part of the Rwanda Revenue Authority in 1997 and functioned as a separate unit dealing with the enforcement of the compulsion to fill in tax returns, assessment, collection (including the recovery of arrears), auditing, taxpayers' education and registration (IMF No 4/2000, RRA Annual Report 1998). Before 1998 most of these enterprises were not paying taxes, so the first operation undertaken by the newly established Revenue Authority was to audit and collect arrears.

The activities of the Large Enterprises Unit boosted the country's total income from taxes. By April 1999 the large taxpayers unit had been able to recover 11 billion Rwf in tax arrears from different companies, including public organizations – table 9 indicates that 9.6 billion Rwf of the 11 billion Rwf were collected from 15 large public enterprises.

By 2000, the unit under RRA had managed to collect, through ICHA, 7.2 billion Rwanda Francs, and 3.1 billion through the withholdings of 219 big enterprises. In the year 2000 the unit was reported to have completed the auditing of about 102 files amounting to 10 billion Rwanda Francs in tax arrears, and to have filed notes of taxation to 118 companies that were expected to generate about 2.6 billion Rwf (RRA report 2000). The contribution of company tax to total revenue shot up from 3.9% in 1995 to 16% in 1999, although it then dropped one percent in 2000 registering only 15% of total tax revenue in the country (RRA, Report 1999 & 2000).

4.3.2. Why a Large Enterprises Unit?

Establishing a Large Enterprises Unit for efficient tax collection is one of the popular measures in modern tax administration. Tanzi (1995) in Chapter 3 refers to the Large Enterprises Unit as a special functional unit in tax administration, made up of an elite group of better trained and less corruptible officials, it monitors the collection of taxes from large taxpayers who, although there are only a few of them, account for a large part (sometimes as high as 90 percent) of tax revenue from VAT and corporate income taxes. Such a unit can virtually guarantee the timely collection of most of the tax revenue and the prompt identification of stopfilers and delinquent taxpayers, so that appropriate action can be taken, including the imposition of penalties. A large taxpayer unit can significantly reduce errors in tax declarations and can minimise delays in the collection of substantial amounts of revenue due to errors, late filing and other violations of tax regulations. Such a unit properly focuses on initial efforts in tax administration reform and on the adoption of more efficient procedures for important taxpayers, rather than to focus on small taxpayers whose revenue generation is not substantial.

A large taxpayers unit serves as a model for the adoption and expansion of modern tax administration practices. Tanzi (1995, see also Chapter 3) reflects on practical trials with the establishment of the Large Enterprises Unit. He acknowledges that in many countries, large taxpayers units were introduced as pilot projects, thus allowing the tax administration to try out new methods and technologies. The successful implementation of such pilot projects demonstrates to the tax administration, which as a bureaucracy tends to be resistant to change, that it is possible and advantageous to modify procedures and systems. In many countries the large taxpayers units were applied to progressively larger groups and with regard to modern practices. For example, Argentina developed new practices for a group of less than 1 000. It has now expanded the group to more than 200 000 (Tanzi 1995:12).

A large taxpayers unit may take on not just the collection but also the auditing function, for several reasons. The detection of evasion is just as important as the monitoring of compliance with filing and paying requirements. In addition, large taxpayers usually carry out a high volume of transactions and have complex operations. They frequently have several branches of operations and sometimes branches outside the country. They have skilled accountants and lawyers, and may use forms of evasion that are difficult to detect, such as transfer pricing. These characteristics of large taxpayers often make it necessary to establish special monitoring units with highly specialized staff.

4.3.3 Presumptions

The corporate economy in Rwanda is dominated by small enterprises. Most of them are involved in service provision, and they are mostly run on an informal basis. Among the measures adopted in the tax reform program was the introduction of presumptive taxes to facilitate the tax administration of small and medium enterprises.

Table 9 The tax arrears of the 15 Largest Public Enterprises (1999)

Enterprises	Amounts
Air Rwanda	470.2
Banque Nationale du Rwanda	6.4
CER	44.3
Electrogaz	3,939.7
INR	102.4
Imprisco	83.4
ORTPN	61.9
OCIR The	37.9
ONATRACOM	133.9
OPROVIA	22.4
ORINFOR	112.9
RAR	37.7
RwandaTel	3,586.1
STIR	882.7
SORWAL	90.1
Total	9,611.8

Source IMF 2000

In 1996, the government announced the imposition of a presumptive income tax of 3% of their annual turnover on all enterprises. This was followed by the government offering self-employed persons or enterprises with an annual turnover of RF 60 million or less, the choice of paying presumptive income tax of 4% of annual turnover or of paying the regular income tax. This was adopted as one of the government's measures to include small enterprises in the tax net.

As from January 1999, the presumptive income tax rate was reduced from 4% to 2%, with a view to improving compliance. For enterprises with an annual turnover below RF 36 million, however, the presumptive tax became mandatory (IMF No 4/2000).

Before the war there were about 700 informal enterprises in the country, but the number shot up after the war and by 1999 there were about 8 000 small enterprises, mostly operating informally. The nature of their economic operation, in every case, precluded the application of available methods of taxation, yet they were employing a significant size of the urban labour force.

After the establishment of the Rwanda Revenue Authority, small and medium enterprises (SME) also became the focus of a special section of the organization. Most of the small and medium enterprises by 1997 were among those companies with backlogs in tax arrears. But, by 1999, the RRA had managed to recover taxes from SMEs with tax arrears amounting to 110 million Rwf, followed by 340.9 million Rwf recovered in the year 2000. In 1999, the Revenue Authority also managed to collect about 1.3 billion Rwf from SMEs by declaration, while in 2000 the RRA collected about 2,02 million by declaration, and distributed 1 610 notes of taxation to the value of 917 Rwf (RRA Reports, 1999 & 2000).

Tax systems in developing countries are facing the challenge of a big community of potential taxpayers operating outside the tax net. We saw in Chapter 3 that most taxpayers in these countries are typically employed in agriculture or in small enterprises. As they are seldom paid in regular, fixed wages, their earnings fluctuate and many are paid in cash off the book. The income tax base is therefore hard to calculate. Nor do these workers typically spend their earnings in larger stores that keep accurate records of sales and inventories. As a result, modern means of raising revenue, such as income tax, and consumer taxes, play a diminished role in these economies (refer to Tanzi Chapter 3).

In the light of this argument, Musgrave (1990: 299) (see Chapter 3) divides taxpayers into four distinct categories:

1. Very small taxpayers, who should be exempted
2. Small taxpayers, who should be subject to presumptive tax in lieu of other income tax and sales tax
3. All other taxpayers, who should be subject to the regular system of filling in returns and declarations
4. The hard to tax group, for which the system of review is based on estimation.

Tanzi in Chapter 3 regards presumptive taxes as one of the best approaches for the taxing of small and difficult to tax groups. Under a presumptive tax system the taxable income of a small business is computed indirectly on the basis of certain objective indicators, such as the value of goods for sale, the number of employees, total wages paid, and the amount and type of physical assets. Estimating taxable income on a presumptive basis can, however, require considerable effort on the part of the tax administrator.

4.3.4 Exemptions

Before 1994, tax exemptions and deductions were the main features of the tax system in Rwanda. At the inception of the tax reform program in 1995, the removal of exemptions became the central agenda. In 1995 government started the process of reducing tax exemptions and combating tax evasion. The process included a review of the investment code so as to streamline incentives for investment and make them more transparent (IMF, No 4/2000). This was criticized for being designed in a 'hidebound' way, referring to the relationship that existed between some government officials and some big businessmen in the country - a relationship consolidated by the former corrupt tax system.

The Code on Direct Taxation enacted in 1997 consolidated the anti exemption campaign, and included measures aimed at reducing exemptions on the importation of personal effects, reducing the privileges of public enterprises, non-governmental organizations and religious entities, and compelling military personnel to pay income tax. Sales tax, previously set at 5% for essential consumer goods and 10% for other goods and services, was standardized at 10% for both domestically produced goods and for imports. The series of exemptions had been limiting tax equity and the economic efficiency of the tax system. Removing these exemptions also resulted in the termination of the existing investment code on the allegation that it was providing suspect incentives.

The newly introduced investment code prescribes a number of incentives for investors, including;

- The reduction of customs tariffs on raw material and intermediate goods required as inputs for the production sector
- Reduction of income tax rates
- Accelerated depreciation of plant and equipment aimed at reducing taxable capital
- Profits in the first years of operation
- Exemption from import duties and sales tax on plant, machinery, equipment or construction materials that are not obtainable in Rwanda
- Investors will be entitled to first arrival privileges covering such items as cars, office equipment, personal and household effects

- Following liberalization of the money markets, repatriation of dividends has been made very flexible and easy
- There are proposals for externalization of funds by a foreign investor.

Investors are entitled to a refund of duties and sales tax payable on imported goods.

Tax incentives have been used by developing countries all over to attract foreign investors and promote investment in general. In his discussion of this issue, however, Tanzi (2000) raises a couple of issues about this approach. He indicates that;

- Tax incentives can be abused by existing enterprises posing as new ones through nominal reorganization, and their revenue cost becomes high
- Foreign investors base their decision to enter a country on a host of factors (such as natural resources, political stability, transparent regulatory systems, infrastructure, and skilled work force), of which tax incentives are not the most important consideration
- Tax incentives could also be of questionable value to the foreign investor because the true beneficiary of these incentives may not be the investor but rather the treasury of his home country. This can come about when any income spared from taxation in the host country is taxed by the investor's home country.

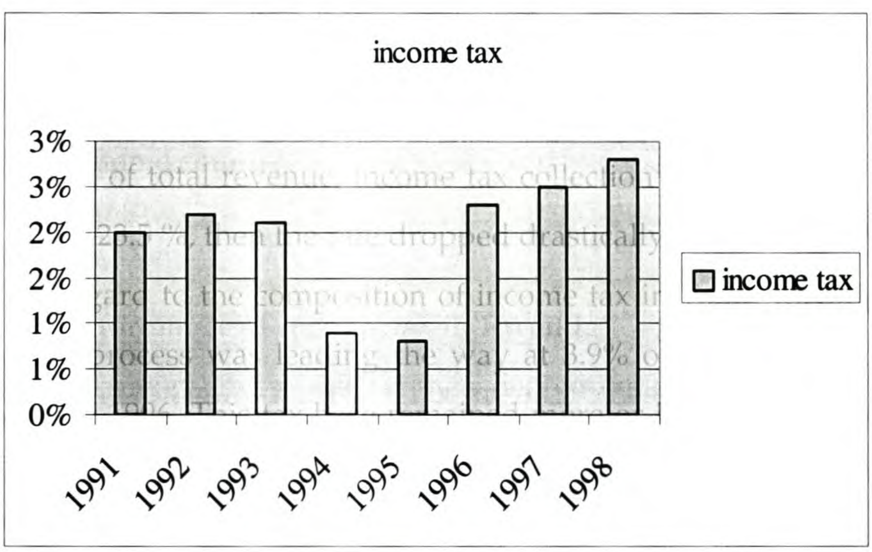
4.3.5 Performance of income tax in Rwanda

According to Figure 2, income tax since 1995 has made a substantial contribution to the Rwandan tax structure. By 1998 it was contributing 2.8% to the national GDP, from 2.5% in 1997, 2.3% in 1996, 0.8% in 1995 and 0.4% in 1994. Before that, from

1991 to 1994, income tax collection had shown mild growth only. In 1991 it was contributing 2.0%, while in 1992 it stood at 2.2 % and at 2.1 % in 1993.

In terms of total revenue, income tax collection at the peak of the 1994 massacres reached 23.5 %, then the rate dropped drastically in 1995 to 12.1 % of total revenue. With regard to the composition of income tax in Table 4, company tax during the reform process was leading the way at 3.9% of income tax collected in 1995, to 16.8% in 1996. This tax base remained more or less constant with contributions of 16.0% in 1997 up to 19.2% in 1998. Individual income tax formed 6.9% of income tax collected in 1995, 6.9% in 1996, showed a slight increase to 7.4% in 1997, dropping to 6.1 % in 1998.

Figure 2: The performance of income tax per GDP from 1991 to1998



This difference between the performance of individual income tax and company tax is the result of the reform effort that concentrated on recovering corporate tax, by establishment the Large Enterprises Unit, removal of the number of exemptions, and taxation of public enterprises. In 2000, however, personal income tax had improved to 11% of the total tax revenue, from 10.2 % in 1999. In contrast, company tax dropped form 16.8% of total tax revenue in 1999 to 15.5% in 2000 (see table 10).

Table 10 The income tax performance per tax base

	1995	1996	1997	1998	1999	2000
Company tax	3.9	16.8	16.0	19.2	16.8	15.9
Individual tax	6.9	6.9	7.4	6.1	10.2	11.5
Others	1.3	1.8	1.0	1.7	-	-
Property tax	0.4	0.8	0.7	0.8	-	-

Source: IMF Report No 4/2000 & RRA Report 2000

4.4 CONSUMPTION TAX

Tax reform initiatives in Rwanda are also aimed at improving the performance of consumption tax or indirect taxation. This type of reform includes different measures for imports and exports taxation and for excise duties. In the course of reform, consumption tax became a major focus as it was contributing 70% of total tax revenue (RRA, 2000).

Commodity taxation has remained a major source of tax revenue, not only in Rwanda for the last century but also in the rest of sub-Saharan Africa. Findings on tax policies in sub-Saharan Africa are that any tax reform in these countries should focus on clearing possible distortions of consumption tax while employing possible instruments of commodity taxation, including:

- Broad based consumption tax such as sales tax and value-added tax (VAT), as a mechanism for generating revenue

- Commodity specific taxes such as excise tax are used to introduce a degree of progressivity in commodity taxes and compensate for the presence of externalities
- Import duties are limited to providing protection if required to domestic producers
- Most export taxes should be eliminated.

Right from the beginning of the reforms instituted in 1995, the tax authority in Rwanda started clearing the distortions in the import section by removing a series of exemptions on imported goods and balancing rates between imported and domestically produced goods. The sales tax rate previously set at 5% for essential consumer goods and services was standardized at 10% for both domestically produced goods and imported goods. The collection of sales tax on imports was shifted to customs for better administration, and specific tax rates for beer and soft drinks were increased by 70%.

At the end of 1995, the improvement in the contribution of taxes on sales of goods and services to the GDP became pronounced. It had increased from 1.4% in 1994 to 2.9% in 1995. This upward trend was maintained in 1996 with an increase in specific consumption taxes on alcohol, soft drinks, and petroleum. The sales tax revenue shifted from 2.9% in 1995 to 3.3% in 1996, and in 1997 it went up to 3.9%, while in 1998 it was estimated to be 4.5% of GDP. Reforms in consumption tax were dominated by the increase in excise taxes. By 1999 excise taxes on cigarettes and beer had been raised from 60% to 80%, on wines and spirits from 60% to 90%, on soft drinks from 35% to 60%, and on petroleum products from 25% to 60%.

Despite improvements, taxes on international trade have not been doing well. In 1995 taxes on international trade was 2.6% of national GDP, in 1996 2.7%; in 1997 it increased to 3.3% while it declined in 1998 to 2.5%. The fundamental cause of this decline included poor import tax collection owing to the fact that a wide range of exemptions were granted to international and non-governmental organisations, and diplomatic missions. As a result almost 50% of imports were exempted from import duties, and turnover and effective rate duty collection amounted to only 1.6%. The majority of exempt products are consumer goods (52%), with other exemptions applying to capital goods (27%), intermediate goods (16%), and petroleum products (5%). In 1999, in line with objectives under CBI, the maximum import tariff rate was reduced from 40% to 25%, and intermediate rates from 20% to 10%, to 15% and to 5% respectively, while most of the capital goods remained zero-rated. A second causative factor was that the export tax on coffee was eliminated (IMF 2000).

The Rwandan tax system is composed mainly of three taxation regimes: income tax, taxes on goods and services, and taxes on international trade. Of these three types of taxes, sales tax is still contributing the lion's share. In 1994 sales tax contributed 39% of total revenue according to table 12, in 1995 it increased to 49.9%, but dropped in 1996 to 36.5%. It increased again to reach 37.7% in 1997, and then increased further to 42.2 % in 1998. The contribution of taxes on international trade was 36.6% in 1994, but as it is shown in this figure increased to 38.5% in 1995, dropped to 29.2% in 1996, again increased to 31.8% in 1997, and declined in 1998 to 23.9%. Compared to other sources, taxes on income and profits have been the least impressive performers.

Table 11 Production of principal manufactured goods and minerals

	1995	1996	1997	1998	1999(est)
Manufactured goods					
Beer (million liters)	49.1	59.4	76.3	65.0	53.5
Non-alcoholic (million liters)	14.3	18.8	26.7	36.3	22.1
Sugar (metric tonnes)	0.0	0.0	0.0	0.0	2.1
Soap (tonnes)	5,019	6,959	7,500	6,966	6,469
Corrugated iron sheets (thousand tonnes)	2450	2,085	4,229	2,588	4,575
Cigarettes (millions)	35.9	128.5	252.9	303.0	217.0
Textile (million meters)	2.9	5.8	8.6	10.3	9.8
Cement (metric tonnes)	36,000	42,452	60,505	58,929	66,291
Minerals					
Cassitterte	247.0	330.0	327.0	330.0	308.0
Wolfram (metric tonnes)	19.2	62.3	42.0	1888.0	122.0
Colombo-tantalite (metric tonnes)	53.9	97.0	224.0	224.0	224.0
Gold (kilograms)	-	-	10.0	17.0	10.0

Source: IMF Report No 01/30-2000

In 1994 income tax stood at 23.5% of the total tax revenue, while in 1995 it dropped drastically to 12.1%, but shot up again in 1996 to 25.4%, decreased slightly in 1997 when it stood at 24.4%, and was raised to 27.0% of total revenue in 1998 (see table 12).

Table 12 Contributions to the total tax revenue (percentages)

	1995	1996	1997	1998
Income tax	12.1	25.4	24.4	27.0
Sales tax	49.9	36.5	37.7	42.2
International tax	38.5	29.2	31.8	23.9

Source: RRA Report 2000

4.4.1 Tariffs

On the one hand tariff reduction continued to impel the performance of international trade taxation into Rwandan tax reform. Apart from affecting the flow of import tax, however, the tariff reductions are not attracting more imports into the country. Under ideal circumstances, lower tariffs would stimulate import volumes and also encourage compliance, thereby mitigating to some extent the potential impact of the lower tariff rates on revenue. Mid-way through 1999, it became apparent that due to a combination of exogenous factors in Rwanda, this was not happening. Import volumes decreased rather than increased despite the lower tariff rates and revenue targets were not being met. The government then decided to impose a temporary surcharge on imports of finished and semi-finished goods in order to balance the budget (Budget Speech 2000).

Though the reduction of tariffs is one of the strategies to make imports affordable to local consumers, it remains a bane to local manufacturers who are still unable to compete in international market. Balancing the advantages and disadvantages of affordability and competition became a challenging experience to the Rwandan tax administration (Budget 2000). In Chapter 2 we saw that the manufacturing sector in Rwanda is among the weakest in the world dealing with small consumables. Table 11, shows that manufactured products are dominated by alcoholic and non-alcoholic beverages, a little sugar production of an estimated 2.1 metric tones, soap, cigarettes, corrugated iron sheets of which the average annual production is estimated to be 581.1 sheets, textiles and cement production. It has to be remembered, as pointed out in Chapter 2, that these products are produced with poor technology.

Reducing import tariffs as part of an overall program for trade liberalization is a major policy challenge currently facing many developing countries. In Chapter 2 we saw that there are two concerns that need to be addressed when embarking on tax reduction. First, tariff reduction should not lead to unintended changes in relative rates of effective protection across sectors. Second, nominal tariff reduction is likely to entail short-term revenue loss. This loss can be avoided through a clear-cut strategy in which compensatory measures are considered in sequence; first reducing the scope of tariff exemption in the existing system, then compensating for tariff reduction on excisable imports by a commensurate increase in their excise rates, finally adjusting the rate of a general consumption tax such as VAT to meet the remaining revenue needs.

4.4.2 VAT

The government of Rwanda in the middle of 2000 introduced Value-Added Tax (VAT) as part of an attempt to broaden the base for sales tax. It was introduced to replace the unpopular ICHA (L'impot su le Chiffre d'Affaires) or turnover tax, decried by the government because it was difficult to valuate, and which ended up encouraging a number of exemptions. In broadening the sales tax base through VAT, the government anticipated increasing its tax productivity from the current 11.0% to 17% of GDP (RRA, 2000).

The VAT system in Rwanda would ostensibly have two rates, namely the standard rate at x% and a zero rate. In essence there will however be three categories, namely standard rate, zero rate and exempt. The VAT design excludes essentials or basic necessities. Items such as basic foods, medical care, educational supplies and common passenger transport are exempt from VAT. Furthermore the coverage of VAT is extended to the commodities currently subject to excise taxes (beer, wine, spirits, cigarettes, soft drinks, petroleum products) that do not attract ICHA (Budget Speech 2000).

The challenge in the introduction of VAT is deciding on a rating system. There are two systems rating VAT – single rate, and multiple rates. Single rates that would include one positive rate (standard rate), zero rate and exempt, are advocated on the basis of its lesser administrative cost. Multiple rates will require lower rates, high rates, zero rated and exempt.

In most cases, as we saw in Chapter 3, countries introduce VAT because they are dissatisfied with their existing tax structures. There are four probabilities why any country introduces VAT (Tait 1988: 9);

- The existing sales taxes are unsatisfactory
- A customs union requires discriminatory border tax to be abolished
- A reduction in other taxation is sought
- The evolution of the tax system has not kept pace with the development of the economy.

Introducing VAT in Rwanda would be in line with the government's policy of reforming tax administration based on the principle of broadening the tax base, while reducing tax rates and of course encouraging compliance. VAT was therefore introduced in Rwanda with the aim of broadening the tax base of sales tax. Sales tax in Rwanda contributes 21% of the total tax revenue. In fact, the process of tax reform is envisaged to improve indirect taxation and to bring reluctant taxpayers into the tax net. The government is also looking at sales tax to fill the gap left by the reduction of tariffs and elimination of export tax. Rwanda is a member of COMESA, the Organization for Common Market for East and Southern African Countries, which demands the abolishment of border taxes for member countries. Rwanda is under pressure to comply, irrespective of the fact that its international taxation continued to dwindle.

4.4.2.1 VAT and indirect taxes

Value-Added Tax, according to Choi (1990: 369) (see Chapter 3), is a tax system in which enterprises are taxed on the value they add to the goods and services they purchase from other enterprises. It is an indirect taxing system, which collects tax at each stage of the production and distribution process. Indirect taxes are types of taxes that are imposed on commodities and are realized through market transactions. Its main characteristic is that the tax burden falls on the consumer. The salesman or merchant from whom this tax is originally collected transfers the tax burden to the consumer through price increases (Nobes & James 1997/98; Black et al 1999; and Mhro, Fourie & Associates 1996).

Indirect tax is based on the benefit principle. One of its advantages is that it is able to bring into income tax nets those small incomes that could not be covered by the income tax system. Most small incomes fall outside the tax net because they are earned from informal sectors, and thus are difficult to calculate. According to Black et al (1999) it is only through purchasing of commodities that they can be taxed (see chapter 3).

The difference between indirect and direct taxation is based on the issue of who pays tax. While an indirect tax is paid through commodity exchange, the direct tax is paid directly by an individual, company or a household. Direct taxation includes tax bases of income tax, property tax and Pay-As-You-Earn tax. Indirect taxes include VAT, excise duties and sales duties.

4.4.2. 2 Advantages of indirect tax

Indirect taxation is levied on consumption. The consumer can substitute his higher taxable consumption for a lower one, and this provides the consumer with the opportunity to make choices. For example, if imported beer is highly taxed and thus expensive, the consumer can choose between imported and locally produced beer.

Consumption taxes can be used to achieve multiple objectives. In Chapter 3, Black et al (1999), argued that consumption tax can be used to correct market failures such as externalities, by increasing or lowering tax. It can also be used as deterrent and protection measures. For example, consumption taxes may be used to protect the environment - those commodities that might have an adverse environmental impact, could be highly taxed to discourage their application. The same applies to health issues. It is common today for taxes on tobacco to be very high in many countries, as a way of discouraging smoking.

Nonetheless, indirect tax is regarded as unprogressive as it contributes to reducing the work effort of a taxpayer. The assumption here is that the opportunity to purchase luxury goods is an incentive for the taxpayer (consumer) to work hard, but because of indirect taxation the taxpayer will be opting for cheap consumption and will lose interest in working. In addition to that indirect tax rates may encourage smuggling.

Indirect taxation has also been recommended as a tool to enable government to regulate trade relations between foreign and local companies. In several countries consumption tax is used to protect locally produced goods from imported ones, through imposing a high tax on the imported product while lessening the tax payable on locally produced goods. This helps to promote the market for local products by promoting local industry.

Tax authorities, especially in developing countries, as we saw in Chapter 3, prefer indirect taxation, because it is relatively simple to administer compared to income tax. Not only that, but also because indirect tax becomes favorable for tax administration because of the limited scope for tax evasion.

4.5 TAX ADMINISTRATION REFORM IN RWANDA

In Chapter 1 we demarcated this study on two parameters, namely tax structure reform and tax administration reform. In Chapter 3 we indicated that a tax system is made up of two principal interdependent elements, namely tax structure and tax administration. In the above paragraphs we concentrated on reform measures taken by the government of Rwanda in reforming the tax structure. In the next paragraphs, therefore we are going to deal with reforms in tax administration.

In Chapter 3 we saw that tax administration refers to an assortment of mechanisms and institutions governing tax administration and compliance. On the other hand, tax administration reform means the reform of mechanisms and institutions of the tax system. The mechanisms and institutions of tax administration and compliance include both readily observable and veiled elements, the legal and procedural framework governing assessment, tax collection, audit, sanctions, appeal, record keeping, as well as information technology, reward structure, disciplines and accountability.

A country's tax administration system represents an institutional arrangement whereby citizens fulfill their obligation to the government to pay tax; for this reason tax administration should strive to be both effective and efficient. As we saw in Chapter 3, tax administration is effective when there is a high level of compliance with tax laws by all citizens. Efficiency is achieved when the administrative cost per dollar of tax revenue is minimal.

Again, according to Chapter 3, tax administration covers a wide area and its impact is widely felt in a country. It involves different aspects of government management, economic and social change and requires encompassing analyses. The analysis made by Tanzi (1995: 5) (see Chapter 3) that provides the basic elements of tax administration reforms, include: an explicit and sustained political commitment; a team of capable, hard working officials dedicated full time to tax administration reform; a well defined and an appropriate strategy; relevant training; additional resources or reallocation of existing resources; changes in incentives for both tax payers and tax administrators.

Tax administration reform is not revenue targeted, but system targeted. It is aimed at creating a sustainable tax system with effective and efficient measures of tax collection. Essentially tax administration reform deals with how tax revenue should be collected. As Birds & De Juntscher (1992) put it (see Chapter 3), the best tax administration system is not simply the one that collects most revenue. More important is how that revenue is raised - that is, the effect of the revenue generation effort on equity, on the political fortunes of the government, and on the level of economic welfare.

A poor quality tax administration may collect large amounts from easy to tax sectors, such as wage earners, while it is unable to enforce taxes on business enterprises and professionals. The level of collection is therefore a somewhat unsophisticated measure of the effectiveness of tax administration. A more accurate measure in tax administration is the size of the 'compliance gap' - that is, the gap between actual and potential tax revenue - and how that gap varies among the different sectors of the tax paying population.

The fundamental objectives of tax reform in Rwanda are to increase tax revenue in the country, by broadening tax bases and improving tax administration and compliance (Budget 2000). Apparently the five-year-old tax reform in Rwanda is aimed at two areas of tax administration:

- Simplification of procedures
- Institutional reform.

4.5.1 Legal and procedural simplification

The legal and procedural framework of tax reform in Rwanda is explicitly focused on reforming the tax structure, which in turn had an impact on simplifying procedures at various levels of tax collection. Included are measures such as presumptive taxes, reducing exemptions. The introduction of presumptive taxes eased the administrative burden of auditing, assessing and filling tax returns for the small taxpayers, while shifting the effort to the collection of taxes from large taxpayers. Similar to this was the reduction of administrative resources, which were being used in administering and calculating the diverse tax exemptions.

Reforming the administrative process started with numerous pieces of legislation passed by the government between 1995 and 1997. Some of these include the 1995 decree and its four subsequent amendments on fixing entry duty tariffs, the Parliamentary Acts on Consumption Tax in 1997, the Code on Direct Taxes enacted by the Parliament in 1997, with its 1998 amendment. The code amended the direct taxation code of 1964, which covered taxes on company profits, individual profits and property. The code of direct taxes covers also tax on professional revenues, on rental revenues, and movable or chattel taxes (vehicles).

This code made it possible to impose taxes on public enterprises and on those enterprises in which the government is a shareholder, as well as on military personnel. At the same time the code withdrew exemptions and deductions that were initially granted to several non-profit making organizations including churches, NGOs and other associations, by the 1964 law. This included also the revoking of the existing investment code that was said to have uncoordinated incentives for investors (IMF Report No 4/2000).

The 1997 Direct Code of Conduct for Direct Taxes came into being after the initial recovery in tax collection through ad hoc measures undertaken between 1995-96. In 1997 government embarked on the ambitious plan of reducing the primary fiscal deficit to 0.9% of GDP, from the equivalent of about 2.2 % in 1996. This improvement required efforts to increase revenue by about 26% (equivalent to about 1% of GDP), which demanded also fundamental reforms in tax structure, which in turn led to the simplification of procedures, and regulations in the administration of certain tax regimes (IMF 2000).

Other measures introduced by the law included the reduction of the period for declaration of tax, from 5 years to 3 years to enable investors to declare their taxes within the concerted framework of three years during which capital is considered able to be turned into profit. Banks were allowed to deduct taxes from the interest of credits, which have no assurance of repayment, and there was a reduction in company and maximum personal income tax rate from 50% to 40%.

The code provided for the conversion of specific excise taxes on soft drinks and alcoholic drinks, cigarettes and petroleum products, into *ad valorem* taxes, and for the introduction of presumptive taxes, which enabled small taxpayers with limited expertise to pay tax.

In the same development, the code simplified rent tax procedures by allowing a taxpayer to deduct the rehabilitation cost of the house. At the same time the code required the landlord to pay tax in advance. The responsibility for the collection of rental tax was shifted to the local authority, which would transfer 80% of the taxes collected to the central government with 20% remaining behind to support the administration of the tax.

The Code on Direct Taxation took a central role in reforming income tax administration, including changes in the penalty structure. The additional tax fine levied upon the unintended offences in declaration liabilities was removed. This however was seconded by the tightening of penalties on the intended default, by increasing the fine from 15% to 18%.

4.5.2 Customs

Since the inception of the tax reform process, progress in reforming tax administration has been mired in legal and procedural loopholes, which dominated the customs authority. All in all most of tax flaws in customs were mainly identified with the administration defaults - fraud and smuggling. Presenting the government budget for the year 2000 the Minister of Finance and Economic Planning identified a number of weak links in customs administration, which have been influencing tax evasion.

To begin with, the surveillance strategy initiated back in 1995 to impound smuggled goods became less effective. Experience was already showing that when smuggled goods are impounded, pending fines and payment of duties, the smugglers would rather abandon the goods and remain underground, thus rendering the surveillance mechanism impractical.

Another common area of customs fraud concerns goods in transit. In essence, imported goods crossing Rwandan borders to the neighboring countries have been crossing without customs clearance, and some of them would end up in the local markets. The reform process has been shifting the tax burden to local traders, whose commodities have been facing severe competition from illegally imported goods, thus causing conflict between government and local traders.

In addition to that, the warehousing facility provided by the customs authority had become a source of fraud. Importers had been using the customs warehouse MAGERWA to store their uncleared goods for longer than the 12 months allowed by the law. This posed a problem for the customs authority and gave leeway to importers who wanted to avoid paying import duties. Fraud in the customs administration continued to be as rampant as ever because it involved high value products (alcohol, petroleum and liquor) (Budget 2000).

In the light of this situation the government proposed the following special legislation for the period 2000-2001, in order to institute stricter measures:

- To empower the Rwanda Revenue Authority to confiscate and dispose of the goods being smuggled as well as the vehicles used to transport them
- To increase fines and allow the possible seizure of goods and vehicles on violations of transit goods
- Other administrative reform measures to close loopholes
- Reducing the minimum warehousing period from 12 months to 6 months, pending a subsequent review for tightening the period more. Increasing pre-shipment inspection (PSI), whereby the importer that has goods above US$ 5000 in value must be inspected by SGS. This is expected to consolidate the use of PSI, which mostly was being neglected by the importers thus allowing loopholes for fraudulent purposes
- The monthly reconciliation of SGS valuation with that of customs, and justification of eventual differences between taxation proposed by SGS and effective taxation by customs (this will require only administrative directives)
- Enacting and implementing ministerial decrees to reduce delays in the clearance of goods and improve revenue collection
- Increasing storage fees, by levying penalty charges for late clearance after customs declaration, and reducing the period of storage from 12 to 3 months, after which the goods shall be considered abandoned and auctioned

- Enacting and implementing a directive to reduce transit fraud by limiting the time periods of transit journeys between borders and borders, borders and Customs, and imposing progressive penalties
- Enacting and implementing a ministerial decree to reduce customs fraud and evasion by introducing mandatory clearance by professional clearing agents ("customs broker")
- Improving the coverage of imports subject to pre-shipment inspections (above US $ 5 000) to 90 percent; and report on a monthly basis PSI coverage, based on PSI documents (in addition to customs declaration forms), import value, and tax collected by customs.

4.5.3 Improved tax collection

On improving tax collection government prescribed the following measures:

- Enacting and implementing a revised law on fiscal procedures to reduce the legal delays and the taxpayer's response time to the revised tax assessment between the notice to start a tax audit and the confiscation of assets to collect the tax from 123 to 76 days
- Enacting legislation to establish an independent tax tribune working under the chamber of arbitration that would be able to arbitrate conflicts between tax officials and taxpayers without replacing the judicial courts.

4.5.4 Accelerated auditing of enterprises

Government has also put in place measures to accelerate the auditing of enterprises:

- To complete 1998 tax audits (risk-based) for at least 100 large enterprises with assistance from external auditors under the UK-DFID support project
- Thereafter to complete at least 20 audits of large enterprises per month
- Increase the number of VAT issue-oriented audits to significantly improve compliance, in particular for small and medium enterprises
- To strengthen tax collection through the extension of the *avis-à-tiers détenteur* to clients of enterprises in arrears, and exclusion of such enterprises from public auctions for at least six months
- To strengthen control of exit of excisable goods from factories
- To collect dividends from state enterprises
- To ensure that fees for services and other non-tax revenue are collected in accordance with the services delivered.

4.6 INSTITUTIONAL REFORMS

The conspicuous point in the tax system reform in Rwanda is the reintitutionalisation of the tax system through establishing an autonomous tax revenue authority. It was an historical institutional shift, where the responsibilities of tax administration were decentralized from central civil service to a quasi-autonomous institution. In Chapter 2 we saw how institutional disintegration contributed to the current tax system reform in Rwanda.

At first, the institutional crisis in tax administration was partly a result of a collapse in public institutions after the 1994 genocide and war, when together with other functions of the government; tax collection came to a halt. Similar to that, institutional crises in the administration of the Rwandan tax system were not unknown even before the 1994 genocide. Lack of personnel, corruption and a culture of non-compliance as explained in Chapter 2 was an indication of the institutional disintegration of the centralized tax system. The institutional approach to reforming the tax system in Rwanda is therefore not isolated from the mega public sector reform program and reinstitutionalisation of the new government (see Chapter 2). The principal aim of having a public sector of high quality, as we saw in Chapter 3, underpins the need for an efficient tax system that provides resources for policy implementation.

On one hand, creating the Rwanda Revenue Authority was one of the institutional approaches in reforming the tax system. On the other hand, according to its taxpayer's charter in Figure 4, the Rwanda Revenue Authority was expected to present the image of quality public institutions in terms of good and efficient services. Tanzi in Chapter 3 provided some facts on the performance of public institutions, which also must be reflected in the RRA setting and working. The performance of public institutions depends on many factors including (a) building the tradition of reputation (b) maintaining resource bases for organisations with discretion over their use, (c) the clarity of its mandate, (d) organisational development (e) identification of public incentives (f) the quality of its leadership and staff and (g) the freedom over organizational matters. In the next paragraphs we shall look at how the Rwanda Revenue Authority was established.

4.6.1 Rwanda Revenue Authority

The Rwanda Revenue Authority (RRA) was established as a legally separate entity for tax administration through an Act of Parliament in 1997. It acquired a corporate structure with the strategic objectives of maximizing revenue, while minimizing the cost of collection, and to provide a high quality, courteous and equitable service to taxpayers and the Ministry for Finance (RRA 1998, unpublished). Structurally the RRA came to be composed of the departments of Customs, Income

Tax and of Auditing and Investigation, which were formerly operating separately under the Ministry of Finance.

4.6.1.1 Objectives

According to its taxpayers charter Figure 4, the Rwanda Revenue Authority (RRA) was established as a full-fledged institution for tax administration, with the objectives of providing high quality services to the taxpayer, focusing on encouraging voluntary compliance by providing certainty, fairness in terms of accuracy of tax assessment and share of the tax burden, clearly explained simplified procedures which involve the minimum amount of inconvenience and effort for taxpayers in meeting their obligations, comprehensive taxpayer education on responsibilities and accessibility, training to all staff on communication and taxpayer handling skills and sanctions for non-compliance (RRA 1998, unpublished).

4.6.1.2 Structure of RRA

The Rwanda Revenue Authority was established through an act of parliament, enacted on 8 November 1997. The act defined the new agency as an autonomous public institution established with corporate status. Thereupon the law promulgated the corporate mission of the organization, as it is to contribute to the national development by maximizing revenue at minimal cost.

The law prescribed the supreme organ of the RRA to be a governing board of directors, consisting of eight voting members appointed by the prime minister by way of a ministerial order passed by the Cabinet (Art. 8). The main function of the Board is to review and adopt the organizational policy of the RRA as presented by the management team. Likewise the Board is also authorized by law to exercise the administrative power and powers to depose property to carry out its purpose (Art. 6).

The composition of the Board includes the chairman who is appointed by the prime minister, and the Commissioner-General of Taxes who is the executive secretary of the Board. Other members of the board include the Secretary-General from the Ministry of Finance, the Secretary-General from the Ministry of Commerce and the Governor of the National Bank; the three attend as ex officio members, that is, by virtue of their capacities. The prime minister on their own merit appoints three other members as upright individuals with distinguished personalities in the fields of accountancy, auditing, law, economics and other related fields (Art. 8).

According to the structure of the RRA, below the Board of Governors is the Commissioner-General of Tax. According to Article 20 of the deed of foundation the Commissioner-General of Tax is appointed by an order of the prime minister issued in a cabinet meeting under the recommendations of the board, following an open competition and selection. The Commissioner-General reports to the Board of Governors on day-to-day activities of the organization.

At the third level of the hierarchy in the administration of the RRA is the Management Team, that is, the decision-making organ. The management team is responsible for formulating policies for the organization, which must be submitted to the Board for endorsement. It is responsible for the hiring and firing of junior staff in the organization, and assists the governing Board in maintaining discipline among the staff. According to the law the Board of Governors appoints the management team on a three-year renewable performance contract (Art. 24-28).

The Rwanda Revenue Authority has three major departments: the department of customs, the department of income tax, and the department of audit and investigation. The three departments provide the line functions of the RRA. The supporting functions, which fall under the Commissioner-General, are composed of directorates of Human Resources and Training, Finance and Administration, Taxpayers Education, Management and Tax Information, and of Information Systems and Technology.

4.6.1.3 Finance

According to the deed of foundation, the revenue collected by the RRA is credited to the public treasurer. However, the second paragraph of Article 29 of the Act allows the Revenue Authority to retain a percentage of its annual collection corresponding to the annual budget allocated to the RRA, endorsed by parliament through the ministry of finance in order to run its operations. Despite the public budget finance the RRA is also allowed by law to appropriate other sources of finance such as grants and loans, but with prior approval of the Minister.

4.6.1.4 Personnel

After its establishment, the RRA introduced a new employment policy with a different employment package and incentives relatively higher than the civil service package. By the year 2000 the Rwanda Revenue Authority had about 562 workers, both operational and managerial staff with 1-4 monthly increases between January and March. In January 2000 there were 531 staff members while there were 534 in February and March. In April the number dropped to 527, then rose to 531 and 532 in May and June respectively. But from July to December the number shot up to 561 in July and 562 in December (RRA 2000). In December 1998, the RRA still had only about 463 workers, while by December 1999 the number of workers stood at 506. Between 1998 and 2000 the recruitment average was 33 workers per year (see Figure 3).

In Chapter 3 we saw that in order to maximize the utilization of human resources, tax administration reforms must be free of the constraints resulting from the traditional industrial relations of trade unions. The opportunity of firing according to performance must be allowed; at the same time flexibility in hiring new personnel or reallocating personnel should be allowed. In other words, tax administration reform needs to be free from the traditional labor management influenced by the state and trade unions. Equally important, in Chapter 3 it is advised that, in reforming tax administration, the personnel policy must allow for salary differentiation and the provision of adequate salaries. It must allow the transfer of individuals from lower levels to more productive functions. Incentives and training becomes the core of personnel management in reforming tax administration.

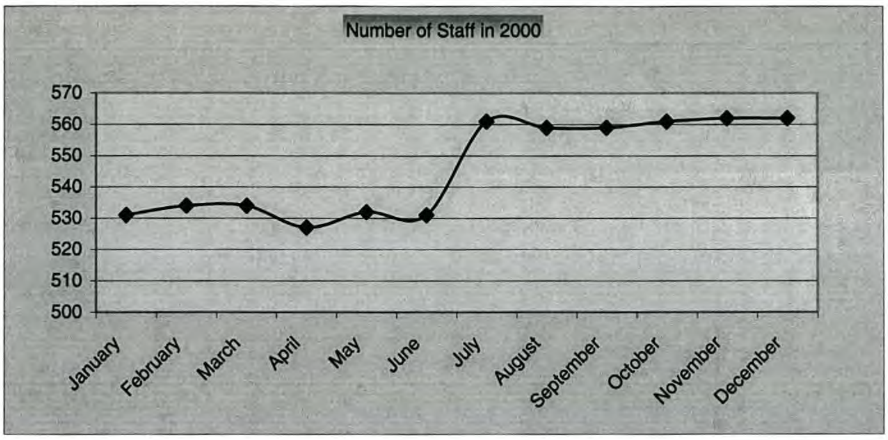
4.6.1.5 Training

The Rwanda Revenue Authority spends a minute percentage of its budget on training: 0.8% in 2000, 1.1% in 1999, and 0.3 % in 1998 (RRA Reports 1999 & 2000). Nevertheless, training has been a resource-consuming function in reforming the administrative capacity of the tax system. In Chapter 3 it was emphasized that training must be designed according to the strategy and objective of reform. For example if the reform strategy is to achieve voluntary compliance, the training of personnel should focus on particular goals to be achieved.

4.6.1.6 Resource allocation

The Rwanda Revenue Authority has spend approximately 5,7 billion RWF from government coffers between 1998 and 2000. The reimbursement of annual budget allocations was being done with deficit. In 1998, the allocated budget was 1.3 billion Rwandan Francs, while the requested amount was 1.6 billion, in 1999, the allocated budget was 2.0 billion while the requested amount was 2.3 billion, and in 2000 the allocated budget was 2.4 billion while the demanded amount was 2.6 billion (RRA Annual Reports 1998, 1999, 2000).

Figure 3: growth of RRA establishment



4.6.1.4 Dynamics of the budget

The critical functions of auditing, tax education and training, have a slim share of the budget. According to Table 13, auditing and investigation are funded at between 0.0% to 0.4% of the total budget, while tax education gets only 1.3% (1998), 2.2% (1999) and 1.9% (2000) of the total budget. The training function is the least favored by the budget. According to the budget allocation the RRA spent only 0.9% of its budget for training in 2000 while in 1999, it spent only 1.1%, and even less in 1998, where training consumed only 0.3 % of total annual budget.

The lion's share of the budget goes towards the salaries of the workers, which consumes more than half of the budget, at an increasing rate - 49.5% (1998), 57.2% (1999). Although seemingly at a diminishing trend, the transport sector and related activities, especially the servicing of cars, comes next. Their share of the annual budget was 14.0% in 1998, 9.8% in 2000, and 11.9% in 1999. The big budget slot, however, is taken up by depreciation costs: 12% (1998), 9.4%(1999), and 5.6% (2000). Administrative elements like maintenance and furniture seem to appropriate a big share, in 1998 these two items had about 12.2% of the total budget while in 1999, they were allocated 11,1% of the total budget. In 2000, the two items dropped to 9.4% of the total annual budget.

4.6.1.5 Information system

One of the millstones to RRA's performance has been the lack of adequate computer facilities and the failure to develop a computerized system. This has been a serious drawback to the integration of information from the RRA's local offices with head office. While modern tax administration continues to depend on a stable and reliable information system that normally caters for both taxpayer and tax administrator, in Chapter 3 we saw that inadequate information systems and communication facilities cause tax systems to perform poorly. In RRA's offices it is a lamenting situation, as expressed in the 2000 budget speech:

A visit to the tax office will quickly confirm the difficulties of working manually with the outdated methods. We will therefore accelerate the computerization of tax department of Revenue so that the collection and assessment of taxes due are closely monitored. In order to reduce the under valuation of imports the customs documentation will be strengthened. Further more there will be staff training especially in areas of tariff tax assessment, accounting and auditing (Budget 2000).

The British government through its ministry of international cooperation is undertaking a project of computerizing and setting up an information system in the RRA. It is providing both technical and financial support to the project. Likewise the British government is also handling the US$ 8 million project of training RRA staff in Flexible Anti-Smuggling Techniques (FAST) to reinforce the capacity of revenue protection service (Budget 2000).

4.6.1.6 Revenue performance

In 1999, two years after the establishment of the revenue authority, revenue performance was mild. The tax collected by the end of 1999 was 71 billion Rwanda Francs, which was considered to be an improvement compared to the previous year's performance at 61 billion Rwanda Francs. But, the performance was falling short of the projected target of 86 billion. Factors to which this was attributed included lower production figures for beer, soft drinks and cigarettes; decline in import volume, delays in completing the presumptive tax assessment of the eligible small and medium sized companies; and poor enforcement of the payment as well as overall decline of economic activities. Besides that, the revenue collection fell short of its 2000 target by RWF 5.2 billion (0.8 percent of annual GDP) by September 2000 (Budget speech 2000).

Table 13 RRA budget expenditure per function (percentage).

	1998	1999	2000
Salaries	49.5	57.3	68.8
Traveling	2.5	3.8	2.8
Benefits	0.0	0.0	0.1
Transport	14.0	11.9	9.8
Maintenance	5.2	2.5	2.3
Furniture	10.9	7.9	5.1
Miscellaneous	3.3	2.6	3.5
Audit & Investigation	0.0	0.4	0.4
Tax education	1.3	2.2	1.9
Training	0.3	1.1	0.8
Board	0.4	0.2	0.2
Depreciation	12.5	9.4	5.6
Consultancy	0.1	1.1	1.2

Source: RRA Annual Reports 1998, 1999, and 2000

4.6.1.7 Changing Revenue Characteristics Over Four Years

Within a three-year period under the reign of the RRA, revenue productivity became more obvious, especially in respect of customs collection that was exceeding other departments by more than half of total collections. According to Table 14, in 1997 revenues from customs amounted to 64% of the total revenue collected, while in 1998 the figure was 61%. It started declining in 1999, when customs collections raised only 59.1% of the total revenue, and declined again in 2000 to 58.8%.

Table 14 Revenue performance per department (percentage)

	1997	1998	1999	2000
Customs	64.6	61.0	59.1	58.8
Income Tax	28.8	32.5	34.1	35.1
Others	5.6	6.5	6.9	6.1

Source: RRA Annual Reports 1998, 1999, 2000

Contrasted with this performance is that of income tax administration, raising less revenue but in an upward trend. In 1997 income tax was contributing 28.8%; the percentage increased to 32.5% in 1998, in 1999 the collection of income tax amounted to 34.1% and 35.1% in 2000. The upward trend in income tax collection in this case has two implications. One implication is that the composition of the tax structure in Rwanda is moving away from a dependence on trade tax to income tax. The second implication is that this changing composition implies that tax administration is slowly improving. Income tax has been a non-performing section of taxation especially in developing countries, because of the demands of sophisticated tax administration systems. By breaking down the tax collection according to the tax regimes in two years consecutively 1999 and 2000 ICHA continued to boom with 21% and 20.7 % respectively. Table 15, shows little variation in terms of personal tax, which was 10% in both 1999 and 2000; corporate tax continued to be a dominant regime at 17% in 1999 and 16% in 2000. The same applies to excise duties which in these two years contributed more to tax revenue than other sources at 29% and 28% respectively; import duties raised 14% in1999 and 13,9% in 2000.

Presenting the 2000 budget, the minister of finance and economic planning told parliament that the shortfalls in revenue performance for the past two years were mainly due to;

- Lower-than-programmed corporate profit taxes, as many companies declared losses (still to be audited)
- Lower beer and soft drink excise receipts, as taxed sales remained extraordinarily depressed
- Lower trade taxes, due to lower declared import volumes; and
- The expected improvements in tax (in particular customs) administration not being realized.

The revenue failure according to the minister's diagnosis was the result of administrative woes still identified with the tax system in Rwanda. In other words the basic elements for tax administration reform outlined in Chapter 3 are yet to be effected in the Rwandan tax reform program.

These elements are: an explicitly and sustained political commitment; a team of capable and hard working officials dedicated full time to tax administration reform; a well defined and appropriate strategy; relevant training for staff; additional resources to the tax administration; changes in incentives for both and tax administration.

4.6.1.8 RRA and Comparative Experiences

The formation of RRA was a major landmark in tax and public sector reform in Rwanda. For the past 40 years the administration of tax collection in Rwanda has been centralized as one of the core functions of the central government. In essence, the ministry of finance was performing both duties, of being the central part of tax policy making and at the same time undertaking supervision and implementation of the policy.

Table 15 Revenue performance per regime 1999/2000

	1999	2000
Personal tax	10	10
Corporate tax	17	16
Property tax	0.0	0.2
Vehicles	1.0	0.8
Excises	29	28.8
Import duties	14	13.9
Surcharge	4	4.4
Others	2	1.8
Warehousing	2	2.3
ICHA	21	20.7
Land	0.0	0.0

Source: RRA Annual Reports 1999, 2000

All in all the formation of the RRA was influenced by the global trend of re-instutionalising a tax system out of the conventional structure of the public service. It is a new outlook that dominated a number of tax reform attempts in the 1990s and 1980s in many African countries, including Uganda, Kenya, Ghana and Tanzania, to mention but a few.

According to Tekper (1999: 171-2), the new approach focuses on harmonizing the functions of different tax units under central coordination. This approach requires the revenue agencies to be established as professionally competent organizations within the public service and civil service in the country. Furthermore, this new outlook of corporate management requires these revenue agencies to have operational as well as functional autonomy from civil service regulations, and it requires the presence of an effective incentive policy for workers and employment procedures contrary to that of central government.

The approach of autonomous tax administration organizations can be traced back to the end of World War II. In 1947, the government of Japan established a national organization for tax administration known as National Tax Administration (NTA). The organization was established with the two main responsibilities of collecting taxes and performing tax assessments nation wide. Actually the organization emerged after the failure of the tax bureau in the Ministry of Finance to perform these responsibilities (NTA, 2000).

Tekper (1999:172) identified two structures, that are common to most revenue authorities in the world. The first is a structure where a revenue authority acts as an apex body established to play a role as head institution. This model is common with East African Revenue Authorities - Uganda and Kenya. With the East African model other revenue agencies such as customs, income tax and their identities, become departments under the unified command of the new structure. The second structure is referred to as the Ghanaian model and entails that the revenue authority is merely a coordinating institution, with the existing tax agencies retaining their autonomy.

Under the East African model, technical and administrative functions are merged in one management service of the authority. In the Ghanaian model, these functions are decentralized. The two models are the result of comparative studies conducted between East African Revenue Authorities - Uganda and Kenya - with the Revenue Agencies Governing Board of Ghana (RAGB) by Tekper (1999: 173).

4.6.1.9 The Philosophy of Revenue Agencies

In Chapter 3 we discussed at considerable length the role of organizational development in the process of tax administration reform. The formation of Revenue Agencies or Revenue Authorities as part of tax administration reforms is to institutionalize the determined functions of tax administration. The idea in short is to organize the tax administration functions and strong organizational structure to improve their effectiveness and efficiency.

Within a functional organization, the workflow within the tax administration is more specialized in order to best support a self-assessment system. The main objective is to identify the exceptions, that is, in the instances of non-compliance. The major part of the staff concentrates on the exceptions, as well as on audits to check compliance. Such an organization entails a strategic element of self-checking among staff whereby the work in one function serves as a control on another. In other words, the organizational structure itself becomes a self-enforcing measure. The revenue agencies as we saw in Chapter 3 are supposed to cover the principal functions of tax administration, including;

- Taxpayer education. Staff members in this function are responsible for educating and assisting taxpayers in tax matters. They distribute printed material that explains tax regulations
- They respond to inquiries from taxpayers. This is a very important function that in the past often did not receive the attention that it deserves. Countries such as Canada, New Zealand and Trinidad and Tobago provide good examples of successful taxpayer education
- Registration, accounting and returns processing. Staff members in this function are responsible for data entries and the processing of declarations and payments. For instance, if a taxpayer uses the wrong tax rate, a computer can detect the error and automatically send a letter asking for

payment at the correct rate. After the data have been verified, they are stored in a master file, which is a central record of all taxpayer transactions with the tax administration

- Collections enforcement. The emphasis of this function is on collection of taxes from stop filers and delinquent taxpayers. Basically, all compliance control except inspection is centralized in this function. The accounting and processing departments provide much of the information that is needed
- Audit. The audit function is devoted to the detection of underreported taxes. Staff members in this function usually perform audits of taxpayers' files and records at tax administration offices, or audits of business activities and records at the taxpayers' premises. It is important to note that the accounting and processing departments have already performed routine checks
- Legal services and appeals. The staff members in this function take cases to court, defend tax authorities against legal appeals in this court, and provide advice as to which actions are legal and which is not

4.7. INFORMAL MAPPING OF PEOPLE'S ATTITUDES

The researcher has been working as a journalist in Rwanda for the last five years up to 2000, with the local weekly "The New Times" and serving as economic news reporter. But one of the primary observations he made on the tax reform program is that it was and is still unpopular among the cross section of the population. Going through shopping centers in Kigali or in other towns, people in different categories, taxi drivers, businessmen, intellectuals, workers, opinion leaders and groups of people in bars and in canteens or restaurants, the dominant complaints are against tax and the Revenue Authority (see figure 5).

Figure 4: Taxpayers charter

It is the right of the Taxpayer in Rwanda to expect the Rwanda Revenue Authority (RRA):

To be efficient

By assisting you to settle tax accurately and promptly

By informing you of your tax obligations

By handling your tax affairs with integrity and in confidence

To be fair

By assisting you to settle your tax affairs impartially

By expecting taxpayers to pay only what the law requires

By proving polite and courteous service

To help you

By informing you of your tax obligations

To put your tax affairs right

By providing clear leaflets and simplified forms

By providing information and assistance to all

If you are not satisfied

R RA will tell you exactly how to complain

RRA will re-examine your tax cases on request

The RRA in turn expects from you

To be honest

To provide RRA with accurate information

To settle your tax obligation on time

Source : RRA (www.rwanda1.com)

There are two possible reasons for this; one is the culture of tax administration. In the former political system tax administration was purely a responsibility of central organs of state, enforced through bureaucratic instruments of state. To put it differently, there have been no taxpayer's participation in tax policies in that the country. The second factor, however, is the introduction of a national revenue agency. There was a feeling among the political authorities and decision makers that the Rwanda Revenue Authority can carry out both its managerial responsibility while also adding political muscle to reform.

Figure 5: Informal mapping of people's attitude to tax reform

We are suffering because of taxes in this country! Informal commentator.

My friend that is the price!! The revenue authority has got no mercy to us! (A retailer talking to client)

Oh! Nothing my friend, this country is full of taxes! (Businessman)

We are paying tax so that people can eat! (A desperate taxi driver)

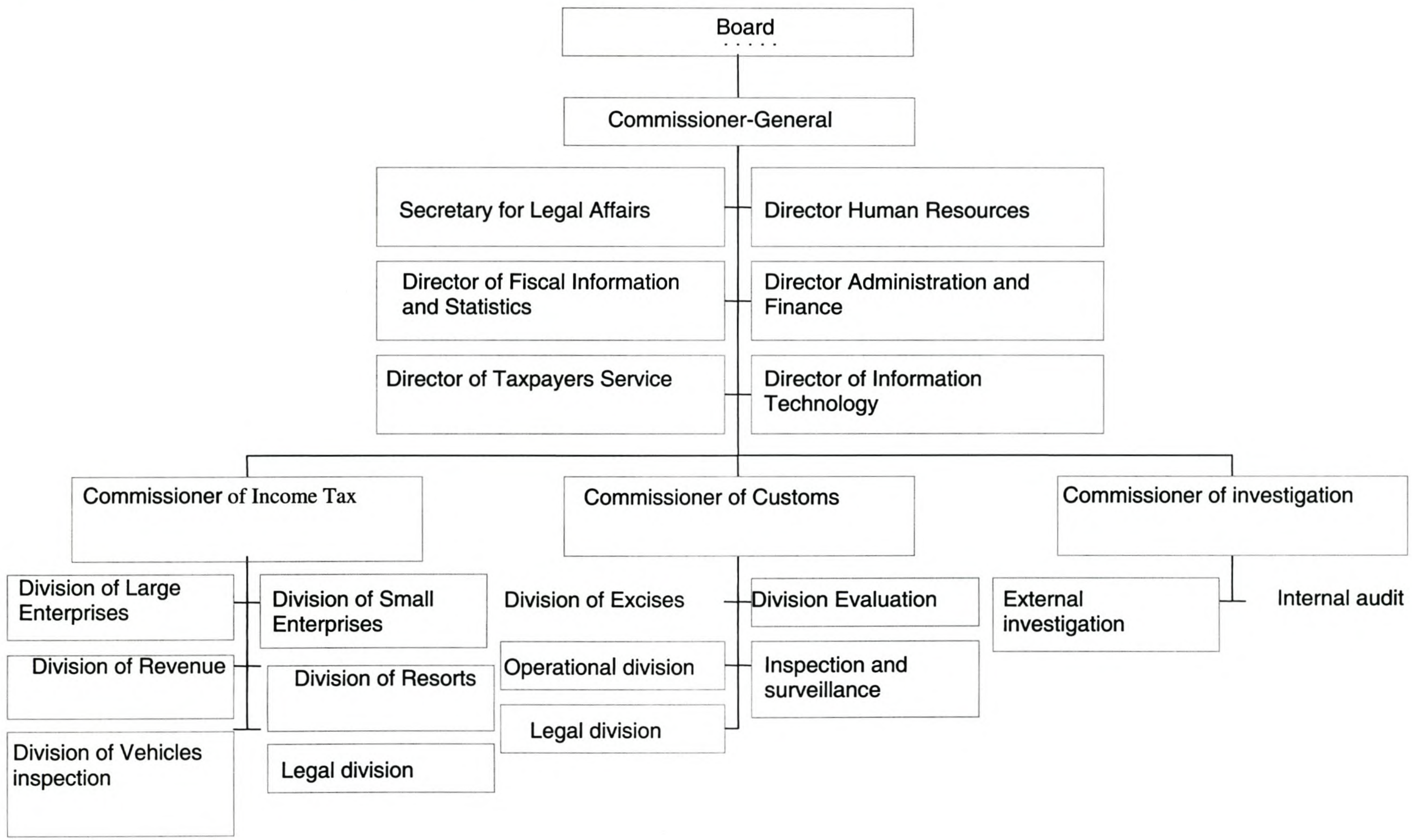
People don't see what this money does! (Informal analyst in a bar)

Let us pay so that people in revenue *authority can eat*! (*Businessman).*

The problem is, we pay tax, but others do not, what can you do? Revenue authority has destroyed everything here! (Importer of consumables)

Oh! These people in revenue authority are really enjoying, I wish I could get a job there! (Graduate strategizing for a job)

Figure 6: RRA ORGANIZATIONAL CHART (RRA Report 1999)



4.8.CONCLUSION

This chapter has provided information on the nuts and bolts that fastened the implementation process of tax system reform in Rwanda. To begin with, the chapter started with the periodisation of the reform process that occurred in two phases, from 1995 to 1997 and from 1997 to 1999. Actually the process is a continuous one, but the two phases were identified deliberately in order to contextualise the reforming of the tax system in terms of the broader macro-economic reform policies, which were being implemented by the government along with the tax reform program.

The first phase of tax reform, 1995-97, was being implemented along with the Economic Recovery Program, adopted by the government in 1995 as an initial step in getting the national economy on track after the 1994 genocide and war. The second phase of reform, from 1997 to 1999, was being implemented along with the Enhanced Structural Adjustment Facility, a macro-economic program adopted by the government with sponsorship from the IMF and the World Bank.

In the first place the implementation process was executed through two reform frameworks for reforming both tax structure and tax administration, as outlined in Chapter 1. In short the reform concentrated on the two components of a tax system, namely tax structure and tax administration. In reforming tax structure, a number of reform measures were implemented to revamp the capacity of income tax regimes, with major emphasis on reforming corporate tax.

Reform measures include the establishment of a Large Enterprises Unit, the introduction of presumptive tax for small enterprises, and re-imposing tax on public enterprises. As a result the performance of income tax regimes started picking up, although it has been initially categorized as the least well performing tax regime in the country. Yet theoretically, as it was observed in Chapters 2 and 3, its sustainability was still unreliable since many taxpayers in Rwanda are still employed in subsistence economy.

Besides that, in reforming tax structure, the implementation process included some measure of reforming consumption tax. Among these was the introduction of Value-Added Tax (VAT). The government of Rwanda introduced VAT in mid 2000, replacing the unpopular turnover tax ICHA with the aim of improving the performance of sales tax.

The chapter covers also the process of institutional reform initiatives in reforming the tax system. A landmark is the formation of an autonomous revenue authority in Rwanda, the Rwanda Revenue Authority. This new organization was formed with the objective of introducing a corporate management approach, which in any case is expected to improve the institutional capacity of the tax system in the country. By and large the creation of the Rwanda Revenue Authority changed the tax landscape in Rwanda. The new organization changed the institutional arrangements of the tax system in Rwanda by absorbing former tax agencies such as Income Tax and Customs as departments under one structure.

The chapter also went further in analysing tax administration reforms. Apart from introducing new institutions, the tax administration reform included measures to simplify tax procedures and institutional regulations. In terms of procedures and regulations, different procedures were changed to improve tax collection. These included the removal of exemptions and other forms of tax incentives. Procedures and regulations were also adopted to improve the performance of customs and accelerate the auditing of small enterprises.

Finally, it was found that the establishment of the new tax authority and other reform measures enabled the government to register performance records in tax collection, but without meeting the target for 1999 and 2000. The identified setbacks were caused by, *inter alia*, lack of competent personnel and equipment, and especially a serious impediment in information technology facing the Rwanda

Revenue Authority. In the next chapter, therefore, we are going to look at salient features patterning the entire subject of tax system reform in Rwanda, draw more interpretations and finally make some recommendations.

CHAPTER 5: INTERPRETATIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

This chapter reflects on the findings of the research. In Chapter 1 the research problem, based on the implementation dynamics of the tax system reform in Rwanda, was formulated. In addition to that, the research hypothesis, the theoretical framework, research design and methodology were outlined. In Chapter 2 the background to the problem was described, making it clear that policy decisions on reforming the tax system Rwanda have been beleaguered by historical, fiscal and structural disequilibria, the explosion of social crises resulting from the 1994 genocide and their harrowing effect on the ailing national budget, the institutional crisis in the public sector and the total downfall of the public realm in the post-genocide society.

On the basis of an in-depth scrutiny of the available literature, Chapter 3 outlined the normative requirements of a tax system, theories on the principles of taxation, tax systems and their relation to the functions of the government, tax systems and the quality of the public sector, the properties of a good tax system and its applications in developing countries. In Chapter 4, an analysis of the operationalisation of the reform process was given. The implementation process of tax system reform in Rwanda was examined with reference to the reforming of the tax structure and tax administration, reforms in administrative and legal procedures, and the institutional set-up.

This chapter therefore is focusing on salient features reflected in this research;

- **Hypothesis testing** regarding regular tax administration, tax structure and resources mobilisation, followed by **Recommendations,** which emphasised **budget re-allocation, outsourcing,** and **decentralisation** of tax system in Rwanda
- **Agenda for further research** on Rwandan tax system, **Summary and Conclusion**

5.2 HYPOTHESIS TESTING

In Chapter 1 it was hypothesized that the success of tax system reform in Rwanda was blurred by inappropriate trajectories of tax reform. The trajectories for tax reforms as was explained in Chapter 1, include the reform of tax structure and administration of a tax system; participation of stakeholders or inclusivity (see Figure 7); and resource mobilisation. The findings presented in Chapter 4 actually showed different degree of inconsistencies in application of tax system reform trajectories, including the gap persisted in reforming tax administration and tax structure, high degree of exclusivity which stifled the participation of tax payers, politicians and other interest groups, and shortage of resources.

5.3 TAX STRUCTURE VS TAX ADMINISTRATION

The two components of the tax system, tax administration and tax structure, were identified in Chapter 1 as the objects of analysis, likewise in Chapter 4 we saw that the implementation process of reforming the tax system was organized around these two parameters. In Chapter 1 it was indicated that tax administration and tax structure are interdependent components of the tax system, which must be dealt with together if successful tax reform is aimed at. In other words the success or failure of the attempt at reforming the tax system is evaluated by looking at the implementation of both. As it was defined in Chapter 1, the term tax structure refers to the configuration of tax bases and tax rates provided for by legislation and/or decrees. The term tax administration refers to the institutions and mechanisms of the tax system, and includes the procedural and legal framework of the tax system as well as the technical part of tax system such as auditing, information technology, defaults control mechanisms, and application of penalties.

As far as the Rwandan case is concerned, the relationship of the two variables in the reform process is manifested in three scenarios:

- The reform performance manifested in successful structural reforms including the broadening of the tax base and altering tax rates
- The reform performance of tax administration reform based on structural simplification of tax system
- The reform performance of tax administration subdued with the imminent lethargy in improving the technical functions of tax administration - tax auditing, collection, information technology and detection of tax evaders.

1st Scenario

The findings outlined in Chapter 4 indicate that tax reform in Rwanda seems to have impacted significantly on tax structure, more so than on tax administration.

In other words the reform process achieved a lot as far as broadening the tax base and tax rating is concerned. The argument is confirmed by such measures as the introduction of presumptive tax, waiving of tax exemptions and deductions, the introduction of Value-Added Tax, and other measures. Not only that, the structural performance of tax reforms also went deeper with the reforming of tax rates, including decisions on balancing tax rates for imports and domestic goods, the reduction of tax rates for income tax from 50% to 40%, increasing of excise duties on alcohol, cigarettes and soft drinks, and reduction of tariffs.

2nd Scenario

Tax administration reform has a twofold function; the first is to create a simple and fair tax structure, while the second part of tax administration reform is meant to create enforcement capacity, that is, the technical capacity of the tax administration to enforce compliance with tax law.

From the above definitions, the first function of tax administration is the structural simplification of the tax system. This involves reforming tax procedures, tax regulations and laws to facilitate the taxpayer's compliance. Generally speaking, the material evidence provided in Chapter 4 shows that the reform process in this area has registered sufficient success with a number of laws and regulations being enacted to facilitate compliance. This legislation included the enactment of the Code on Direct Taxation in 1997, which cleared some hurdles in income tax administration, and the 1997 Act for the establishment of an autonomous revenue agency, the Rwanda Revenue Authority (RRA).

3rd Scenario

Yet scenario three shows fallout in the trend of reforming tax administration. The second part, the technical part of tax administration - auditing, assessment, collection and information technology, could not make it through. Instead it was mired in a lack of resources. As a result, therefore, the expected revenue performance in 2000 could not be attained despite the institutional build up and policy measures which were put in place by the reform process to increase tax collection.

In summary the three scenarios showed that reforming a tax system involves reforming the following:

- Tax structure - changing, adding or reducing the tax base and tax rates.
- Tax administration - changing the procedures and regulations of taxation.
- Tax administration - improving the technical capacity for tax system auditing, assessment, information technology and management, skilled personnel and efficient managerial systems.

It is true that there has been a tendency among tax analysts to emphasize structural simplification of a tax system as a core requirement for successful tax system reform. Actually the rhetoric has been that complicated tax regulations and tax procedures always complicate a situation for a taxpayer, making it difficult to comply with his/her tax obligations. Furthermore, tax analysts are of the opinion that a simplified tax structure facilitates attempts to bring the small taxpayers into the tax net. However, according to Bahl & Vaziquez (1992: 83), simplifying the tax structure alone cannot ease the bottlenecks of tax administration. The level and speed of economic modernization continues to complicate tax structures, thus demanding technically sophisticated tax administration.

The changes in economic trends are rendering the orthodoxy of structural simplification insufficient, to say the least. These changes include the financial structures of domestic companies with numbers of middlemen and financial intermediaries, the dominance of electronic transactions (e-commerce), shifting from a commodity-based economy to the service economy. These and other trends are imposing new demands on tax administration that is paramount in a sophisticated and technical tax administration system.

5.4.RESOURCE MOBILISATION

In Chapter 1 it was hypothesized that the success of reforming the tax system in Rwanda was blurred by deviating from appropriate trajectories of the tax reform process, including according to Tanzi (1995) in Chapter 3, an explicit and sustained political commitment; a team of capable, hard working officials dedicated full time to tax administration reform; a well defined and an appropriate strategy; relevant training; additional resources or reallocation of existing resources and changes in incentives for both tax payers and tax administrators. In fact, the findings in Chapter 4 revealed that the implementation of tax system reform in Rwandan suffered a setback of availability of resources. This, of course, concurs with the hypothesis.

Implementation of any reform policy requires mobilisation of resources. According to the logical division by Grindle and Thomas (1991: 127), there are four types of resources required for implementing public policy reforms. These include financial, political, managerial and technical resources, which if ordered logically, are reduced to two; **bureaucratic resources** (financial, managerial and technical), and **political resources** (public support and stakeholders participation). To put it differently, implementation of reforms requires both bureaucratic and political capacity of implementing agencies.

5.4.1 Bureaucratic resources

It is common knowledge that there is a shortage of bureaucratic resources in Rwanda, that is, financial, technical and managerial resources. As it is was stated in the three scenarios above, because of a lack of resources, the reform measures implemented could not make any headway in improving the technical capacity of the tax system - auditing facilities, information technology, reliable registration, limited skills and others requirements for the enforcement of good policies, procedures, and regulations. The fundamental issue was the lack of financial resources to acquire the necessary technology to support tax administration. The second issue was the lack of technically qualified personnel.

Of course this situation is not surprising to Rwanda, if we refer to the problem situations in Chapter 2. Tax reform in Rwanda was implemented in the midst of an economic crisis, and institutional and social crises. First the internal sources for revenue were already rendered obsolete because of historical and economic problems worsened by war and genocide in 1994. Secondly the dilapidated civil service resulting from the events of genocide and war could not provide human capital for any reform initiatives.

In brief, the implementation of tax system reforms in Rwanda could not mobilize local resources, whether these are financial, or technical or even managerial resources. In addition to depending on external finance, the implementation of the reforms also depended heavily on external technical expertise.

All in all, the possibility of averting the resource situation in Rwanda tax system is still illusive. The present budget allocation to the Rwanda Revenue Authority is still dominated by deficit. In Chapter 4 we saw that in 1998, the allocated annual budget to that authority was 1.3 billion Rwandan Francs, while the requested amount was 1.6 billion. In 1999, the allocated budget was 2.0 billion while the requested amount was 2.3 billion, and in 2000 the allocated budget was 2.4 billion although the requested amount was 2.6 billion. Similar to that the allocated budget is unlikely to meet the sophisticated technical demand of modernizing a tax system, as the big share of the budget is for current expenditure. In 2000 the current budget was 92.5% of the entire budget, in 1999 it was 86.7% and in 1998, 80%.

5.4.2 Political Resources

Implementation of public policy requires the mobilization of political support. Political resources, according to Grindle & Thomas (1991), above all, mean the broad-based public support for the policy implementation. Therefore, the interest groups, popular and political groups as well as the public at large must be mobilized to support the reform. Otherwise, according to Grindle and Thomas, the policy has no legitimacy.

Mobilisation of political resources means the participation of different stakeholders in policy implementation. Participation of taxpayers in implementing tax policies is an important item on the agenda among tax analysts and specialists. Brinkerhoff and Goldsmith (see Chapter 3) have recommended that the participation of taxpayers in tax reform be achieved through the participation of civil society in fiscal policy.

The implementation of the tax reform policy in Rwanda failed to mobilize enough political resources. The process marginalized completely the agenda of taxpayers' participation in the process. The reform policy documents do not indicate at all the role of other role players - local authorities, business community, workers, and other members of civil society. Major stakeholders were the government, through the Ministry of Finance and the Rwanda Revenue Authority, while the important patron was the donor community. In essence, there was scant involvement of political institutions and personalities in the process of implementation. The role of political personalities, parliamentarians, local leaders, cabinet ministers in the process was not streamlined either.

Needless to say, there was an alienation of taxpayers, so is lack of political inputs in implementation of tax reform processes in Rwanda. As we saw in Chapter 4, this created public discontent among sectors of the Rwandan community. Tanzi (1999) refers to the necessity of involving political personalities in tax reform, saying that:

- Genuine tax reform will require time as well as commitment from the country's government, which will have to use up some of its political capital in order to bring about changes in the system (government with a long horizon)

- Tax reform is expected to succeed with a politically powerful government, which is stable, has stamina, interest, and vision for reform. In this respect Tanzi warns against a government whose members keep changing, as this limits the chance for successful tax reform

- Successful tax reform requires equilibrium between political objectives, tax policy change, and administrative development. All of these have to move together

- Adaptation of reform to domestic economic conditions. Reflecting on technical tax advisors, Tanzi insists that there is a need for substantial domestic participation in the reform process, and the need to spend a lengthy period in studying the characteristics of a country.

From the above observations there is no channel for the voice of a taxpayer in the tax system. The current structure of the Rwanda Revenue Authority does not accommodate any form of representation for taxpayers in decision-making. In the first instance, the state's representatives, being in policy formulation or in the implementation process, override the composition of its Board of Directors, which could be expected to be more representative.

Amongst the eight members, four are government officials who become members by virtue of their posts in government offices, including two secretary-generals from the Ministries of Commerce and Finance respectively. Other state heavy weights on the Board are the Governor of the Central Bank and the Commissioner-General, while the Prime Minister appoints the rest in their individual capacity, including the chairman who is appointed by the cabinet. Indeed the established law does not provide for any group's representation in the management of the RRA or in any structure of tax administration.

5.5 RECOMMENDATIONS

The achievement of tax system reform in Rwanda has two sides to it. On the one hand tax reform has succeeded in introducing relatively good tax policies. On the other hand, the success of the implementation process is slowed down by the lack of resources to transform the technical capacity of the tax system, thus putting a strain on revenue performance. Technical functions - auditing, tax collection, detection of tax evasion and tax assessment - are still characterized by crude methods of work. Unfortunately the possibility of rectifying the issue of scarce resources in tax system administration in Rwanda is still out of reach, therefore not only the reform performance but also the stability of the tax system in Rwanda will remain shaky, as the resource capacity to maintain whatever is achieved will continue to be limited.

The transformation of the tax system in Rwanda may also for some time still be hampered by a general lack of compliance with tax laws, because of two reasons. First, a great effort will be needed to change the attitudes of the historically non-compliant community. As we saw in Chapter 2, the culture of paying tax among the Rwandan population has had a very low profile compared to other countries in sub-Saharan Africa. Second, as it was indicated in Chapters 2 and 4, small and informal income earners dominate the Rwandan tax community.

A great deal of effort will still be necessary to bring them into the tax net. So is to change the attitudes of the elite community who lack a sense of obligation as citizens. Then there is also the unprofessional business community that is fond of smuggling and corruption. Implicitly therefore, the success of reforms to the tax system in Rwanda is subject to economic and socio-political crises which still need to be unfolded altogether. Accordingly the mobilisation of resources for reforming the tax system in Rwanda will have to take into consideration all the factors above. To start with, however, the tax authority in Rwanda needs to examine some of the following issues:

5.5.1 Budget re-allocation

The RRA and the government of Rwanda at large need to re-assess the policy on resource mobilization to enable not only successful tax system reform but also sustainability of the system. RRA needs to review its annual budget allocation in favor of strengthening the technical capacity of tax administration. The primary alternative will be the shifting of resources from lower productive tasks to those tasks of high productivity. For example, the Rwanda Revenue Authority can determine how its wage bill that seems to consume more than half of its budget can be reduced and set to it that the difference be re-allocated to an investment in information technology. As was shown in Table 4, salaries consumed 68% of the total budget expenditure of RRA in 2000, while functions like auditing took up only 0.4%, training 0.8%, depreciation 5.6% and consultancy 1.2%.

Consolidating and upgrading the information system will have the effect of replacing a number of jobs, from managerial to supporting staff. For instance, auditing with computerized support will reduce the number of files to be audited per one auditor, therefore reducing the number of auditors needed. To implement this, broader incremental approaches will have to be adopted. The two projects must go together, that is, informatization of the organisation and retrenchment of staff. This will require the merging of departments, and the downsizing of some activities. From this approach some resources can be saved towards the service and maintenance of technological aids, and supporting the remaining small number of staff to be able to provide good services. The scale effects of downsizing will automatically include the reduction of expenditure on personnel benefits and other administrative costs.

5.5.2 Outsourcing

The Rwanda Revenue Authority has to conduct a study on how it can start outsourcing some of its tax administration functions to private operators without compromising its control. Commissioning and subcontracting to operators, professional organisations, private companies, and other public institutions including banks, to undertake some of the tax administrative functions, are valid options to strengthen capacity.

The outsourcing, in terms of scaling down the labour force, as discussed above has the advantage of creating an outlet for the readjustment of the working force. The organization will opt more often to use consultancy services rather than maintain a big establishment of workers. It is also expected that the retrenched experts with tax knowledge and experience acquired from RRA will be able join or form consulting firms on tax matters who will be engaged by Revenue Authority as an independent consultants.

Outsourcing can also be practiced through engaging independent organisations, community organizations, business organisations and others in collecting taxes from their members with specific commissions. The important thing is to assist these associations in updating their financial management. Civil society can also be engaged in tax education programmes. The advantage of this approach is twofold. Firstly, it reduces the administrative cost of tax administration. Secondly, it is one of mechanisms for taxpayer's participation in tax administration, which eventually encourages voluntary compliance. As it has been observed, in Chapter 3 the role of taxpayer participation in tax policymaking and implementation is becoming a critical issue for attaining voluntary compliance.

This has long-term and broader effect on the tax system. Apart from the envisaged reduction of resource expenditure on labor force in the operation of the tax system, the devolution of tax resources to private people serves to enlarge the source of policy advocacy as one step for the mobilization of political resources, which is discussed below.

The outsourcing of certain functions of tax administration, as we saw in Chapter 3, is not new in tax administration today. Countries such as Bolivia and Indonesia have been hiring specialized companies to check the value of imports. Owing usually to the absence of control systems at customs, this type of service basically involves checking the value reported by the importer against the prices in order to establish the duty payable (Ramireza Acuna 1992: 387).

Among the reliable institutions which tax authority all over the world work with are banks. RRA may as well augment its contracts with banks by commissioning to the different banks more responsibilities on tax collection. Countries such as Bolivia, Brazil, Ecuador, Chile, Uruguay and Columbia have assigned a major role to banks in tax collection. Generally this was done, first because of lack of resources in tax administration in handling sufficiently tax collection, but secondly also this was done in recognition that banks are already specialized in handling payments (Bird & de Juntscher 1992: 7).

5.5.3 Decentralization

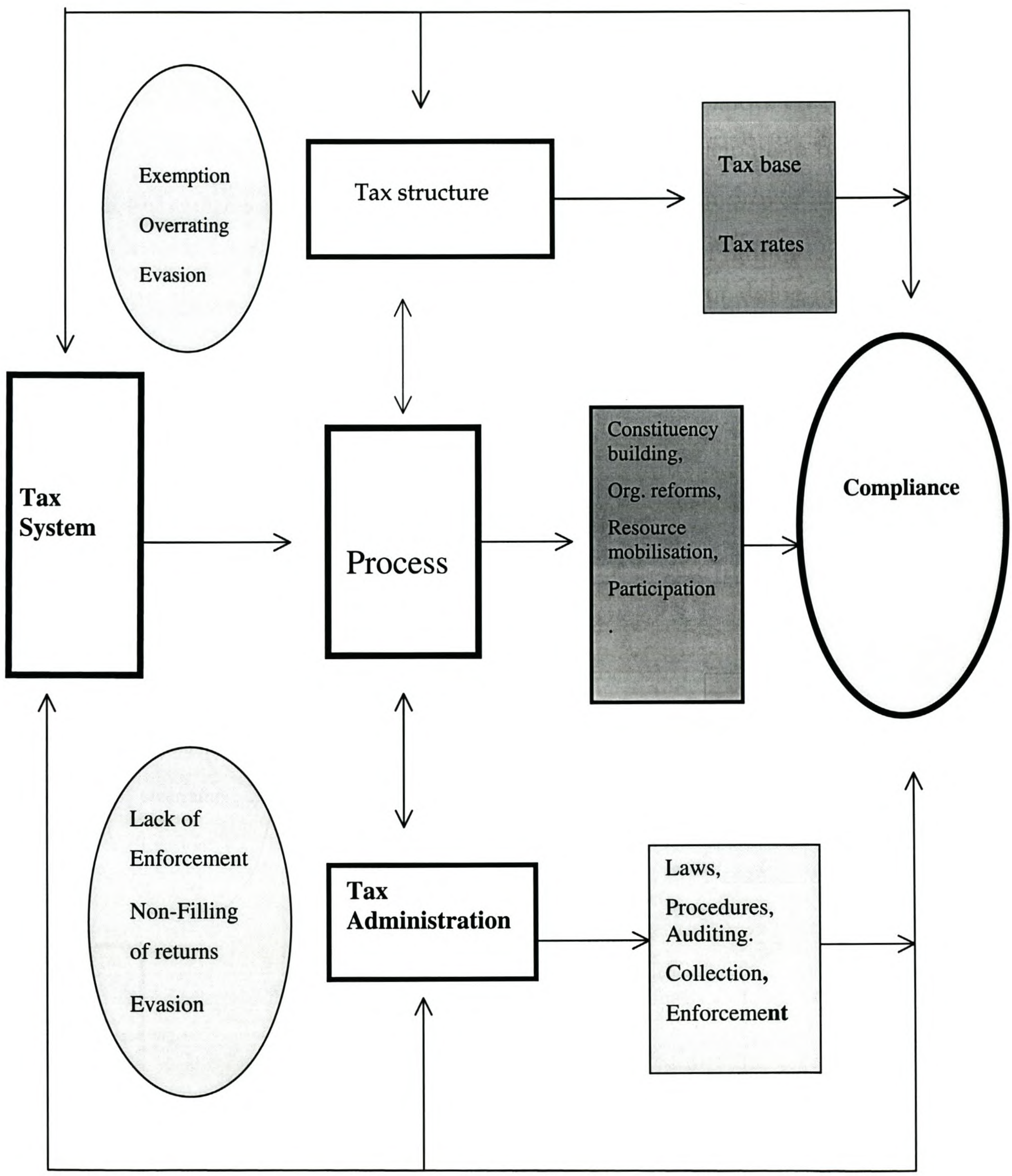
The Rwanda Revenue Authority needs to work out how the local authority can participate effectively in tax administration. This will have a scale effect in resource mobilization. First, as most of the taxpaying enterprises in Rwanda, as seen in Chapters 2 and 4, are informal, small and scattered, including those in rural areas, collection of taxes from these groups is administratively costly, with little returns. Using local authorities therefore makes sense. Second, because of this nature of its taxpayers, the Rwandan tax system will continue to depend on presumptive methods of taxation, therefore the collection of such taxes can work effectively through decentralized structures. For instance taxes from small traders in local markets can be collected and administered by the local authority. Another advantage of the localization of tax collection is that it gives local political structures the responsibility of tax policy advocacy. It is not necessary that the RRA should use the established local government structures. It can design its own structures, which will be easy to monitor but operate as facilitator of tax collection, and not as a supervisor.

5.5.4 Democratization of the tax system

Tax system administration needs to be more democratic to allow civil society to take part in tax education awareness campaigns and to participate in deciding on changes in tax system. Taxpayers' participation should be improved through the involvement of CSO, local leadership, dissemination of tax information, not only through the media but also through the seeking of advice or doing consultation with different groups of people whose members are directly or indirectly affected by the tax changes. These groups should among others include:

Workers organizations, youth, women and women representatives groups, as well as businessmen from different groups, professionals and others. Senior politicians, including the president, members of cabinet and MPs should be directly involved in tax awareness campaigns instead of leaving the responsibility to the Ministry of Finance and the Rwandan Revenue Authority.

Figure 7: The scenario of tax system reform



5.6 FURTHER RESEARCH

This thesis provided an analysis of the dynamics of implementing tax system reforms in Rwanda. Further research is needed to evaluate the tax system reform in Rwanda and its performance in terms of the cardinal principles of a good tax system, namely **efficiency** and **effectiveness** as well as **equity**. Much is yet to be done in finding out the performance of the Rwandan tax reform program in terms of efficiency and equitability. On a general perspective the successful tax reform must be assessed on the basis of how it is promoting equity and fairness among the taxpayers, the rate of simplification and how it avoids economic distortions.

5.6.1 Efficiency and effectiveness

Research is needed to evaluate the efficiency and effectiveness of tax administration. Tax analysts believe that tax administration should be evaluated on the principle of efficiency and effectiveness in collecting taxes.

According to Silvan (1992: 255 in Tanzi 1995) the efficiency of tax administration is gauged by how much is spent in collecting revenue. To put it differently, tax administration becomes efficient when there is less expenditure per revenue collected. Rwanda Revenue Authority for example in its 1998 report revealed that it spent 1 Franc to collect 44.9 Francs, while in 1999 the collection ratio was 1 Franc for collecting 30.8 Francs. In 2000, the report shows that 1-Franc was needed to collect 27.2 Francs (RRA Reports, 1998, 1999 and 2000). Provisionary it can be said that there is an element of efficiency in tax administration, but not according to the trend for the cost of tax collection that are getting higher annually. The ratio of 1 Franc per tax collected declined by 14 Francs between 1988 and 1999. The same applied in 2000, the revenue per Franc decreased at about 3.6 Francs, which is a point of recovery. But between 1998 and 2000 the average trend of decline amounts to 17.7 Rwf.

At the global level the annual budget can be used too in determining the relationship between administrative cost and revenue collected per year. In 1998 the allocated budget was 1.6 billion Rwanda Francs while revenue collected was 62.9 billion Rwf. However in 1999, revenue declined to 62.3 billion Rwf, while the budget increased to 2.0 billion Rwf. In 2000 revenue collection increased from 62.3 billion Rwf (1999) to 65.3 billion where the budget increased as well to 2.4 billion.

5.6.1.2 Effectiveness

Silvan (1992: 275), when distinguishing between effective and efficient tax administration, maintains that the maximum level of voluntary compliance is a reflection of the effectiveness of tax administration; yet, the level of enforcing compliance at the maximum low rate will determine the efficiency of tax administration.

Performance indicators for the effectiveness of tax administration, according to Silvan (1992: 275) are how the following four gaps are getting reduced:

1. The gap between unregistered and registered taxpayers; this shortfall originates from the gap between the registered taxpayers and potential taxpayers
2. Stopfiling gap resulting from the difference between registered taxpayers and potential taxpayers according to the law
3. Tax evaders gap resulting from the difference between the tax reported by the taxpayers and the potential tax according to the law
4. Delinquency gap resulting from the amount of taxes a taxpayer reports owing or that the tax administration may eventually assess and tax actually paid by taxpayers (Silvan 1992).

Below are some evaluating questions that can be used to assess the four gaps in Rwanda.

Q 1. Compliance for the last four years

Year	**1997**	**1998**	**1999**	**2000**
The number of taxpayers registered with the large taxpayers unit				
The amount of tax collected from large tax payers as a percentage of total tax revenue				
The number of taxpayers registered as small taxpayers				
The amount of tax collected from small taxpayers (% age of total tax revenue)				
The amount of tax collected through withholdings (%age)				
The number of taxpayers who file their returns through banks				

Q. 2 The level of non-compliance for the last four years

Differences	1997	1998	1999	2000
The difference of registered taxpayers and potential taxpayers				
The difference between the registered taxpayers and those who file returns				
The difference between the tax reported by the taxpayers and potential tax according to the law				
The difference between the amount of taxes that taxpayers report owing and actual tax paid by the taxpayers				

Q. 3 The progressive assessment of voluntary compliance for the last four years

Year	1997	1998	1999	2000
The number of taxpayers who file their returns voluntarily				
The number of taxpayers who can perform self-assessment				

5.6.1.3 Current Agenda for Research in Tax Administration

The tax authorities in Rwanda, tax analysts and academics interested in the development and stability of the Rwandan tax system can as well focus their attention of research on such topics which are world wide currents in tax administration:

- How the application of user charges would be a productive revenue base to supplement sales tax as the main source of tax revenue. User charge is a recommendable form of taxation in poor countries where the hard to pay group is big
- Research is needed on the application of the principle of private-public partnership in tax administration in Rwanda, in order to reduce the administrative cost of taxation and promote taxpayer participation
- How tax administration can be centralized through local government structures as a way to facilitate the taxation of the rural community
- The measurement of tax 'gaps' and the real resource cost (administrative, compliance efficiency, evasion) of an alternative tax structure and administrative procedure
- The relative effect of penalties, information systems (reporting) simplicity (in laws), publicity on compliance
- The use of presumptive tax for 'hard to tax' sectors
- The efficiency with which audit resources are allocated and possible analytical bases for the administrative rules of thumb and decision rules used with returns for examination
- The pros and cons of the 'large taxpayer' approach
- Appropriate compensation for third party collection agents (for example banks)
- The cost and benefits of 'tax amnesties'; the administrative implications of rate differentiation and exemption
- The incidence and locative effects of judicial procedure. Possible systems for linking administrative rewards to administrative efforts

The topics are currently in urgent need of research in tax administration world wide, in view of improving the efficiency and effectiveness of tax systems, and tax administration for that matter. According to Bird and de Juntscher (1992:8), the above topics are of immediate importance to the developing countries.

5.7 SUMMARY AND CONCLUSION

Broadly speaking tax reform in Rwanda formed part of a major program of public sector reform by the new government after more than three decades of degeneration. The 1994 genocide event, referred to frequently in this paper, was just the culmination of a crumbling neo-colonial state institution. Owing to a lack of competency and capacity in tax administration, corruption and the lack of political sense of responsible citizens among the population, and dependence on the primary economy, the tax system has not been able to ensure sufficient compliance with tax laws.

The Rwandan tax reform started in 1995. Practically it was a technocratic project designed by the local policy elites and international consultants. Apart from the political process of enacting legislation, the rest of the process was left in the hands of government bureaucrats and external expatriates through the newly established Rwandan Revenue Authority. The implementation process was a top down process; the role of other stakeholders did not prevail either.

Though it was not explicitly made clear, the failure of the tax system in Rwanda is the result of what was described in Chapters 1 and 2, as structural and fiscal imbalances. The variable of the 1994 genocide and its effects appeared to be central to our discussion but was just an extension of the crisis of institutional crumbling of public governance (Chapter 2).

Tax system reform in Rwanda was among the best reform policies adopted by the new government in Rwanda. Yet its implementation suffered from the lack of resources. As a result the changes had more impact on reforming tax structure than tax administration, because of a lack of resources to build technical capacity for the new tax system.

The research is the result of secondary data collection and analysis as well as literature review. Chapter 1 of this thesis dealt with the process of conceptualizing the research problem. The chapter contained the theoretical framework, research methodology and design. Chapter 2 dealt with the background to tax reform in Rwanda; it revealed the contradictory policy circumstances that persisted before and during the decision of reforming the tax system in Rwanda, which influenced and affected policy decisions, and the organization and implementation process. Chapter 3 contained a literature review, which provided the normative requirements of a tax system. It covered the theory of taxation and its impact in determining the relationship between the state, citizen and economy.

Chapter 4 analyzed the processes undertaken in implementing tax reform in Rwanda. We saw that the implementation was organized according to the macro-economic reform programs, implemented through tax administration and tax structure reforms. Lastly, Chapter 5 provided interpretations, recommendations and conclusions. It tried to dissect the process of implementing tax system reform in Rwanda, its failures and successes as well as policy recommendations, which underscored the need for more resources mobilization and public support to enable successful tax system reform.

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